Federal-Provincial Fiscal Arrangements in the Eighties

A Submission to
the Parliamentary Task Force on
the Federal-Provincial Fiscal Arrangements

By the Honourable Allan J. MacEachen
Deputy Prime Minister and
Minister of Finance

April 23, 1981

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1. INTRODUCTION

I must first thank the Task Force for inviting me to inaugurate its public hearings and for providing me with this opportunity to share with Members of Parliament and Canadians at large some of my thoughts on the current state and future direction of fiscal federalism in Canada. The Government has begun, in consultation with the provinces, a review of the federal-provincial fiscal arrangements. Such a review has taken place every five years since the practice became established some 35 years ago. This review, which must be completed some time before April 1, 1982, will largely determine the nature of fiscal relations between our two orders of government through the better part of the 1980's. I hardly need to dwell, therefore, on the importance of your mandate, but I should like to say precisely why it is so important.

The first reason derives from the very nature of fiscal federalism. Intergovernmental fiscal relations are a central and irreplaceable feature of our federal system. They provide an essential bridge between the two orders of government - mechanisms whereby the measure of flexibility required for effective government is introduced in the division of taxing, spending and legislative powers prescribed by the Constitution. Accordingly, fiscal relations determine the means whereby the federal and provincial governments through joint or coordinated action pursue a number of policies essential to sustain our political union and ensure effective operation of our economic union. These basic policy objectives fall into three broad categories, to which correspond the major features of intergovernmental fiscal relations and which I will elaborate upon below: tax harmonization, economic and fiscal policy coordination, and intergovernmental transfers.

Consequently, whenever Parliament amends the legislative basis of the federal-provincial fiscal arrangements, as it is called upon to do at least once every five years, it alters a fundamental structure of our political and economic union.

This brings me to the second reason why the mandate of this Task Force is of critical importance. The most widely known components of the fiscal arrangements are of course the considerable federal tax and cash transfers which Parliament has decided should be made to provincial governments. In 1981-82 these transfers will amount to about \$19 billion. Cash transfers alone are estimated at almost

$14 billion for the fiscal year and will account for over 20 per cent of the total budgetary expenditure approved by Parliament. Moreover, an overwhelming proportion of these transfers are made under statutory provisions which are normally in place for five years and which make it very difficult for the government to alter its priorities.

Accordingly, intergovernmental transfers loom very large in the government's medium-term budgetary planning. Once the relevant legislation is in place, the financial requirements for intergovernmental transfers are a major constraint on the funding which the government can ask Parliament to provide for other government programs, including those which are under its exclusive jurisdiction and to which the government may attach a high priority. It follows that the conclusions and recommendations of the Task Force will bear not only upon the federal-provincial negotiations leading to the revision by Parliament of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977. They will also influence overall budgetary planning and resource allocation at the federal level throughout the five fiscal years from 1982-83 to 1986-87.

Hence, it is only fitting that Members of Parliament should be called upon to review and make recommendations on the fiscal arrangements. That is why the government has agreed to set up this Task Force, and why I announced on February 25 that we would await its report before making a firm proposal to the provinces. This will not prevent us, of course, from pursuing in the meantime our consultations with provincial governments.

It is important that Canadians be well informed about these arrangements and, more generally, about the evolution of fiscal relations between the federal government and the provinces. That they have not shown more interest may be because the arrangements work very well. But another reason may be that too many have persuaded themselves that these arrangements are much too arcane and complicated for the layman to understand. This view is largely unfounded. I assure you that the nature and basic purposes of the fiscal arrangements are quite easy to understand. I feel rather strongly that this lack of interest is undesirable. For there is some danger that the remarkable achievements of the Canadian federation in this regard could be eroded in the near future.

The mandate of this Task Force is therefore additionally important because of the clear need to inform the Canadian public of what is at stake in the current review of the fiscal arrangements. In this respect, I am very pleased that the mandate of this Task Force has been modified to allow it to hold hearings in the various parts of Canada.

You will be reminded that the fiscal circumstances of our various provincial governments vary greatly, that some derive enormous revenues from the exploitation of natural resources found in their provinces while the revenues of others from such sources are insignificant, that some have high income tax yields because of the concentration and productivity of resource, manufacturing and service industries in their territory, while others have access to much lower yields. You will observe that provincial tax systems have special features reflecting local conditions or preferences.

In other words, you will be reminded that the diversity of Canada is not only linguistic, ethnic and cultural, but that it is economic and fiscal as well; and that this fiscal diversity is of paramount importance in designing the most appropriate fiscal arrangements for the 1980's. Despite its time constraint the Task Force will no doubt want to hear the views of provincial governments and other interested parties. Needless to say, the Task Force can count on my full support and co-operation in its undertakings.

At this time, I thought it might be useful to share with the Task Force the government's assessment of the current state of fiscal federalism in Canada. It is also incumbent upon me, as Minister of Finance, to emphasize the critical importance of the fiscal arrangements which will apply from fiscal year 1982-83 onward for the successful implementation of the budget strategy I announced last October. Finally, I will attempt to identify those issues which we consider most critical at this juncture and on which the government would particularly welcome advice from the Task Force.

2. NATURE OF EXISTING FISCAL ARRANGEMENTS

My point of departure is obviously the arrangements which are currently in place. They consist of the three closely integrated features which I have already mentioned.

First, tax harmonization. The major feature of tax harmonization allows the federal government and the provinces to exercise their respective powers of income taxation in a manner which helps to foster tax harmony and to decrease the complexity of the income tax system. It also reduces significantly the cost of tax collections and simplifies procedures for taxpayers. This is achieved mainly through Tax Collection Agreements under which the federal government collects the personal income taxes levied by all provinces except Quebec, and the corporate income taxes of seven provinces - Ontario, Quebec and Alberta being important exceptions.

The administration of these agreements requires close co-operation between the federal government and the provinces of which, I suspect, the Canadian public is largely unaware. In 1981-82, the federal government will assess and remit to the participating provinces on their behalf over $9 billion worth of provincial income tax. Except for a nominal administration fee for certain tax credits, provincial taxes are collected free of charge. This represents a substantial saving for provincial taxpayers. Of critical importance also are the rules, so far accepted by all provinces outside of the agreements and hence applicable to all of Canada, governing the allocation of the income of corporations operating in more than one province, the determination of the province of residence of individuals for tax purposes and the allocation of their business income earned in other provinces.

Other examples of tax harmonization are the intergovernmental taxation arrangements. Under the Municipal Grants Act, the government makes grants in lieu of municipal and provincial property taxes on federal property holdings across the country. The grants will amount to over $160 million in 1981-82. Under the Reciprocal Taxation Program, the government has entered into agreements with the six easternmost provinces, under which it pays, as if it were taxable, provincial consumption taxes and motor vehicle licenses. Payments under the program will total over $130 million in 1981-82. Participating provinces in turn bear federal indirect sales and excise taxes.

The second, and perhaps least visible feature of federal-provincial fiscal relations is the arrangements for fiscal and economic coordination. These arrangements are not formalized and do not have a legislative basis, but they play an important role in the joint management and periodic review of the other two facets. Central to this coordination mechanism are the meetings which federal and provincial Ministers of Finance or Treasurers hold regularly, at least once a year and usually prior to budget time, to review the economic outlook and consider what would be the most appropriate budget response by each order of government. A Continuing Committee of Officials deals with technical issues relating mainly to fiscal arrangements and tax collection agreements, and prepares a common basis of economic information and analysis for ministerial meetings.

Ministers at their pre-budget meetings are concerned primarily with the appropriate budgetary and borrowing positions of all eleven governments for the coming year, that is, with the macro-economic aspects of fiscal and economic coordination. Preparations for and follow-up to these meetings have given rise to extensive consultations among federal and provincial officials on a wide range of

economic and fiscal issues. These consultations merge on a day-to-day basis with technical discussions related to the administration of the Tax Collection Agreements and intergovernmental transfer programs. Important "outputs" are the jointly prepared fiscal forecasts and the underlying economic assumptions which are used in budgetary planning by both orders of government.

Much of the preparatory work to coordinate provincial participation in the 1975 wage and price control program was carried on within this structure. The economically innovative, though politically difficult, sales tax reduction of 1978 was organized there. There is a network of other intergovernmental consultations and arrangements which are concerned primarily with micro-economic aspects of fiscal and economic coordination. These are frequently concerned with specific policy and program issues. In addition, there have been occasional attempts to structure more formal federal-provincial coordination in broad policy areas, such as the multi-tiered consultations which led to the 1978 First Ministers' conferences on the economy.

The effectiveness of these arrangements is somewhat obscured by the informality and confidentiality and by the adversarial element which the politics of federalism frequently inject in its public manifestations. Some may therefore too easily dismiss the progress made in the past two decades. That our eleven governments can now prepare their budgets and make adjustments in their broad economic policies on the basis of common economic assumptions and fiscal projections is a major accomplishment which, in itself, has made the federal and the various provincial fiscal stances more compatible.

The third and best known feature of the federal-provincial fiscal arrangements is the intergovernmental transfers. The federal government makes unconditional or conditional cash and tax transfers to provincial governments for a wide variety of purposes. The three major intergovernmental transfer programs are those which the Task Force has a mandate to examine: these three programs account for about 90 per cent of total federal outlays of that type. I shall describe them briefly.

The Fiscal Equalization Program provides for annual, unconditional payments to provinces which have a below-average capacity to derive tax revenues and, consequently, below-average capacity to finance public services for their residents. The purpose of equalization is to make it possible for these provinces to provide reasonable levels of public services without having to resort to levels of taxation which

are unduly high. The purpose of equalization is not to redistribute provincial revenues. In 1981-82, six provincial governments will receive equalization payments totalling $3.6 billion. Per capita amounts vary among provinces according to their fiscal capacity - from $765 for Prince Edward Island to $291 for Quebec. The legislative basis for Fiscal Equalization is found in Part I of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977.

The Established Programs Financing arrangements provide for an equal per capita federal contribution to all provincial governments for the funding of Hospital Insurance, Medicare, Extended Health Care and Post-Secondary Education. In 1981-82, the federal contribution will amount to about $470 per capita. The total value of contributions, which are made in the form of cash payments and tax transfers, is $11.4 billion in 1981-82. The cash payments require federal outlays of some $6.4 billion, while the tax transfers reduce federal revenues by $5.0 billion. These arrangements provide not only for joint financing of established programs but also for a degree of harmonization of provincial health care systems. I emphasize that, while federal contributions for health and post-secondary education have become less conditional as a result of the shift in 1977 from cost-sharing to block-funding, and while no program conditions have ever been attached to post-secondary education, the health components of the transfer are still very much conditional upon provincial compliance with the terms and conditions laid down in federal legislation administered by the Minister of National Health and Welfare. The basis for EPF payments is defined in Part VI of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, but the authority and conditions for the Hospital Insurance and Medicare cash payments are still found in the Hospital Insurance and Diagnostic Services Act and in the Medical Care Act.

The Canada Assistance Plan provides for federal cost-sharing, on a 50:50 basis, of expenditures incurred by provincial governments for social services and income maintenance. The primary eligibility requirement is that provincial expenditures be based on the "need" of the recipient. In 1981-82, total federal contributions under CAP amount to $2.0 billion, to which must be added the value of a tax transfer to Quebec in respect of the Canada Assistance Plan under contracting-out arrangements - about $300 million.

These, then, are the major components of federal-provincial fiscal arrangements. There are numerous other financial links between the federal government and the provinces, many of which are described in the supplementary

material accompanying my submission. Elements of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, other than those I have described are quite important even though they do not involve significant federal outlays, and the Task Force may therefore want to examine them. I am referring, for example, to the provisions of the Act regarding the stabilization and guarantee of provincial revenues, which many provincial Finance Ministers or Treasurers find quite useful when they negotiate their borrowings. But I suggest that the Task Force might be well advised to concentrate on the major arrangements which are currently being reviewed by the federal and provincial governments. Before dealing with some of the specific issues relating to these arrangements, I will try to place them in the broader perspective of overall fiscal relations between our two orders of government. What is the current state of fiscal federalism in Canada? How has it evolved in past decades? What direction should federal-provincial fiscal relations take in the future? It is to these fundamental questions that I now turn.

3. THE CURRENT STATE OF FISCAL FEDERALISM

Canada's system of public finance has been in a state of continuous change ever since Confederation in 1867. While many of the early changes were of profound significance, the major elements of our present system have evolved primarily in the period since the late 1950's. This is true, to a considerable extent, of the system of taxation, with its emphasis upon income taxes, consumption taxes and natural resource levies, and to an even greater extent of the system of intergovernmental transfers, with its emphasis on unconditional and block grants.

The present system of intergovernmental transfers has basically evolved since 1957. Since then, federal cash transfers to provinces have increased from \$300 million to about \$14 billion a year. This has come about as a result of three major developments:

(a) a comprehensive system of fiscal equalization has been established;

(b) the transfer system has been used to provide for joint financing and harmonization of health, welfare and post-secondary education programs; and

(c) various other transfer programs have been started, for example, in the areas of economic development and tax harmonization.

Since 1957 the federal government has more than quadrupled the amount of tax room made available to provinces in the personal income tax field, partly by means of tax transfers enabling provinces to finance expenditures in areas of social policy, most notably health and education. As the provinces occupied this additional tax room, they sought more control over the tax structure and this, to a considerable extent, has been accommodated within the income tax collection agreements. Thus while cash and tax transfers were increasing, the federal government was relaxing many of the original detailed conditions under the agreements.

Provinces have therefore gained a bigger share of the revenue pie and additional flexibility. In short, they have become fiscally much stronger vis-à-vis the federal government. Over the twenty-year span from 1959 to 1979, the federal share of total government revenues has declined from over 58 to less than 46 per cent while the provincial-local share has correspondingly increased from 42 to 54 per cent. The decline of the federal share is even more dramatic when intergovernmental transfers are taken into account. While in 1959 the federal government had over 52 per cent of the total revenue pie after such transfers, it had less than 34 per cent in 1979.

The Federal-Provincial Fiscal Balance

As a consequence of these developments, some observers have concluded that there is now an "intergovernmental fiscal imbalance" in Canada. There is no precise or generally accepted definition of the concept of "intergovernmental fiscal imbalance". However, it generally refers to the fact that one order of government has a large and persistent deficit or surplus in its accounts in relation to that of another order of government.

This view appears to some to be reinforced by the coincidental fact that the current federal deficit is roughly equal in size to the aggregate level of federal cash transfers to the provinces. A significant feature of the past few years has been a deterioration of the fiscal position of the federal government to a point where its freedom to initiate policies and programs has become severely limited. At the same time the over-all deficit of provincial governments has turned into a surplus. The seven provinces without oil and gas revenues continue to have deficits, but in total these have been relatively stable.

Interprovincial Fiscal Balance: The Emergence of "Fiscal Dualism"

Fiscal balance has an interprovincial dimension as well as a federal-provincial one. The enormous increase in provincial natural resource revenues has, so far, accrued almost entirely to three provinces, by-passing the other seven. As a consequence, a situation has been created which may be described as "fiscal dualism", with some provinces being much better off than others. A very high proportion of the new resource revenues has gone to a single province, Alberta. Indeed, the gulf which now exists between Alberta and the other provinces is probably well in excess of the gap between rich and poor provinces which has existed at any other time in Canadian history. In the past the most marked departures from national average per capita income or wealth were attributable to a number of provinces that were below average. Now, the most marked departures are attributable to those provinces that are above average.

Comparisons among provinces are most appropriately made by means of indices of "fiscal capacity". Such indices compare the per capita capacity of provinces to raise revenues. This is done by comparing the estimated revenues which each province would receive from a standard tax system, with average provincial tax rates applied to its own (standardized) tax bases. Average rates are used in order to prevent the results for any province being determined by its own level of taxation. The comparisons can be enlarged beyond own-source revenues to include fiscal equalization and other federal transfers, in which case the indices compare the capacity of provinces to derive revenues from own sources plus transfers. Three such comparisons are shown in the supplementary material. I draw your attention to three key observations arising from these comparisons:

- Disparities among provinces are very wide prior to equalization payments, but these payments have the general effect of narrowing them substantially. Disparities are narrowed further if other federal transfers are taken into account.

- Alberta stands out because its fiscal capacity prior to transfers of any kind is virtually double that of any other province and because its very high position is little affected by intergovernmental transfers.

- The three provinces with large natural resource revenues (Alberta, British Columbia and Saskatchewan) consistently rank highest in fiscal capacity.

The fiscal strength of provinces is manifested in various ways. A strong province is able to reduce its level of taxation and/or provide a relatively high standard of public services. In addition, it may accumulate wealth in special funds as Alberta and Saskatchewan have done. Beyond this, a strong province will have the potential to use its tax and expenditure systems for the purpose of promoting various economic objectives, including its own economic development, at times in a manner that could weaken the Canadian economic union. In this latter event, problems of interprovincial fiscal balance may be exacerbated.

Federal-Provincial Political Balance

The issue of fiscal balance within a federation is part of the broader question of the federation's political and economic balance. While there are numerous considerations which determine the political leverage of any government within a federal system, it is clear that fiscal strength is one of them. As provinces, individually and collectively, become fiscally stronger they attempt to increase their political leverage within the federation. At the same time, as the fiscal position of the federal government weakens, its political leverage declines.

In a federal state the exercise of political power is always the object of some competition between the two orders of government. This competition will be the more vigorous if the residents of certain provinces feel that they do not or cannot participate adequately in the exercise of power through the central institutions of government, and if provincial governments can exploit this sentiment to enhance their own legitimacy. To avoid such struggles for power placing excessive strain on the fabric of the nation, it is necessary that the balance that exists in the fiscal and political situations of the two orders of government be capable of continuing adaptation, over time, to reflect shifts in their social and economic circumstances. If these adjustments cannot take place, or if they take too long and lag too much behind the emergence of new realities, then the fiscal and political balance of the federation can be seriously disrupted.

Reasons for change may differ from province to province but they invariably point to a new, more decentralized balance of power between the federal and provincial governments. The current phenomenon, therefore, is somewhat different from most of the previous regional protest movements which have emerged from time to time since Confederation, such as the Maritime Rights Movement and the Progressive Movement in Western Canada. By and large, earlier protest movements sought to improve the lot of a particular

province or region by pressing for more favourable federal policies. At the present time, the emphasis is very much upon further decentralization. As a result, the issue of political balance has acquired considerably greater importance than in the past, and merits just as much attention as the related issue of fiscal imbalance.

Government Visibility and Accountability

The visibility and accountability of each order of government in a federation is a part of the over-all issue of intergovernmental balance in that federation. Any consideration of intergovernmental balance in Canada should, therefore, take account of differences between the federal government and the provinces in respect of these matters. Indeed, these differences are of profound significance. This matter has two distinct aspects: first, the broad public perception of a government and, second, its visibility in respect of particular programs it provides, or to which it contributes financially.

The federal government has responsibilities for many areas where problems tend to be intractable and for which solutions are increasingly difficult to find. These responsibilities include such matters as unemployment, inflation and the foreign exchange rate, as well as foreign policy, national defence, security of energy supply, interprovincial transportation and redistribution of income. The provinces, for their part, together with their local governments, are responsible for many public services which serve local communities and regions. The public which receives these services tends to be well informed as to which government is providing them - because of the proximity of the service - and the visibility of that government is enhanced. In addition, many provincial responsibilities relate to very specific services, such as highways, hydro, health, welfare and education, with which the public can easily identify.

A number of important public services are jointly financed by the federal government and the provinces, most notably in the fields of health, welfare and post-secondary education. The federal government has a particular problem of program visibility in respect of these services because they are delivered by the provinces and because little is done to acknowledge publicly the important federal role. This has implications for public accountability which should concern all Members of Parliament. How can we properly account for what the federal government does with the taxpayers' money, when a very large number of Canadians are not aware that about $14 billion worth of federal expenditures really serve to finance essential provincial and local services?

4. THE NEED FOR NEW APPROACHES

The foregoing analysis leads me to the conclusion that we must strive to restore a more satisfactory political and fiscal balance between our two orders of government, and I would very much welcome any advice the Task Force could provide on how this might be done. In other words, the Government is searching for new approaches to fiscal federalism in Canada and is seeking the views of Members of Parliament on what these might be. As Minister of Finance, I would like to suggest a number of basic requirements which any new departure would have to satisfy.

(a) First, the most urgent priority of the federal government is to strengthen its fiscal position. Transfers to the provinces cannot be insulated from policies of restraint; otherwise, the full burden of such restraint would fall within exclusive federal program areas. This would place the federal government in an even weaker position vis-à-vis the provinces.

(b) Second, the reduction in the federal deficit should be implemented gradually. Insofar as expenditures are concerned, there are major categories of outlay over which the federal government has very little discretion, in particular, public debt charges and major transfer programs to individuals. There are other areas where the government's priorities have increased, most notably economic development. The need to accommodate these priorities requires that savings be made in other areas, including social affairs and transfers to provinces.

(c) Third, there should be a continuing emphasis on equity in respect of intergovernmental transfers. The method chosen to cut back on federal transfers to provinces must respect this emphasis on equity.

(d) Fourth, there is a need to reach agreement with provinces on ways and means of limiting actions by all governments that weaken the Canadian economic union. In the absence of a constitutional solution, this could be achieved by a "code of conduct" which all governments would agree to follow.

(e) Finally, we must find ways to increase the visibility of federal transfers to provinces, particularly those which serve to finance provincial services such as Hospital Insurance, Medicare, Post-Secondary Education, and Social Services and Assistance.

This is required to ensure that Parliament and the federal government are able to account properly to the Canadian people for the one-fifth of the federal budget which flows through to provinces and municipalities.

5. BASIC ISSUES

I now turn to the basic issues which I see emerging in the current review of the fiscal arrangements and on which negotiations with the provinces are likely to revolve. Most of these issues are examined at some length in the supplementary material which accompanies this submission. I would nevertheless like to summarize my views on each of these issues and suggest a number of avenues which the Task Force might explore.

Tax Harmonization

Members of Parliament who are familiar with the Confederation Debates will be aware that our earliest "fiscal arrangements" were closely related to the issue of tax harmonization. The essential purpose of the financial clauses of the BNA Act, 1867, was to establish a harmonized tax system for the four original provinces, while ensuring that they would have sufficient revenues to discharge their constitutional responsibilities. But the addition of six provinces to the federation and the country's rapid development during the following decades placed great strain on our original tax harmonization system. So much so that when the Rowell-Sirois Commission was asked in the 1930s to enquire and report on federal-provincial fiscal relations, it literally had to "hack" its way through an incredible tax jungle.

In the second volume of its report the Commission reported, for example, that the complexity of the situation then existing regarding the taxation of corporations was complex "beyond belief". It found a maze of taxes which had grown "in a completely unplanned and uncoordinated way", and which violated "every canon of sound taxation". The Commission deplored "...the inevitable inequity, lack of uniformity and lack of efficiency arising from the divided jurisdiction". It found that "...investments in different forms of business are taxed at different rates in the same province; investments in the same kind of business are taxed at different rates in different provinces; investments in business operating on a national scale are double- and triple-taxed with no relation to earning power." And so on.

We have come a very long way since the Rowell-Sirois Report. So much so, that Canada has both one of the most decentralized income tax systems in the world and also one of the most harmonized. The conjunction of a high degree of decentralization and a high degree of harmonization in income taxation is a great achievement - perhaps one of the most remarkable accomplishments of Canadian federalism. Other federations have a harmonized tax system - Australia, for example; but in Australia, the central government levies all income taxes, even though the Australian states, like our provinces, have the constitutional power to levy direct taxes. There are other federations, also, with a highly decentralized tax system - the United States, for example; but in the United States, the income tax fields are a veritable jungle. According to a study published recently by the United States Advisory Commission on Intergovernmental Relations, the personal income tax systems of only 12 of the 41 states with broad-based taxes are in substantial or complete conformity with the federal income tax system; and 10 states do not tax personal income at all, or do so on an altogether different basis.

So there can be no doubt that fiscal federalism has served Canadians well and that we should do all we can to preserve the essential features of our existing tax harmonization system. But this requires our urgent attention, for there are numerous indications that the system is under pressure. For one thing, as I indicated earlier, three of our largest provinces are now outside the joint collection agreements for the corporate income tax, and they account for 75 per cent of total corporate taxable income in Canada. These provinces, therefore, are not formally bound by any harmonization rules in this field. Moreover, there are growing signs of increasing variations, both in rates and through special incentives, by non-participating provinces to attract industry into their province. Other provinces, which are bound by the tax collection agreements, feel that they must follow suit to maintain their competitive position, and are seeking additional flexibility under these agreements.

In other words, there are indications of growing tax competition among provinces, and this is threatening the harmonization that has taken decades to put in place. Task Force members are no doubt aware that the Finance Minister of British Columbia, Mr. Hugh Curtis, referred to this problem in his March 9th Budget Address and suggested one possible way of resolving it. "I believe that it is desirable", said Mr. Curtis, "for all governments in Canada to refrain from measures which balkanize the economy of our country. In our discussions, I will advance this view and stress the need for standards - 'codes of conduct' - which will apply equally to both federal and provincial governments". This is an approach which I personally find most promising. I hope that the Task Force will be in a position to explore it.

Equalization

Some time later this year, I hope, Canadians will see the principle of equalization entrenched in our Constitution. There could hardly be a more appropriate time for this major innovation in our basic law, since we will be celebrating in 1981 the 25th anniversary of the establishment of fiscal equalization as a separate federal program. It would be even more fitting if we could mark this anniversary by introducing further improvements in what is already, in my view, one of the best programs of its type in the world. Needless to say, the Government will consider carefully the suggestions which the Task Force may make in this regard. But, we would also welcome your advice on a number of problems which we have identified in the course of administering the existing program.

The fundamental and perennial issue is the adequacy or appropriateness of equalization payments. Are payments too high or too low given the objective of the program? The Task Force will no doubt wish to consider this basic issue.

One aspect of this issue relates to the treatment of natural resource revenues, and in particular the extent to which they are included in the formula used to calculate entitlements. At present, revenues from forestry and water power rentals are included in full; and revenues from oil and gas and metallic and non-metallic minerals are included to the extent of 50 per cent only, except for revenues from oil and gas land sales which are totally excluded. This raises two questions: first, is differential treatment of various resource revenue sources appropriate, and, secondly, if it was decided to treat them the same way, what proportion of natural resource revenues should be covered by equalization?

I must tell you quite frankly that it would be most difficult for me, as Minister of Finance, to consider a percentage higher than the 50 per cent that now applies to oil and gas revenues, given the enormous drain that this would represent on the federal treasury. But in any case, most of the arguments which have been put forward on this issue go in the other direction. They suggest that the weight given to natural resource revenues should be lowered, essentially because the growth of resource revenues available to oil and gas producing provinces does not, in and of itself, bring about a corresponding increase in the fiscal need of other provinces. According to these arguments, failure to make downward adjustments in the proportion of such revenues taken into account would lead to "over-equalization". Indeed, it has been suggested, notably by the government of Ontario, that the existing formula already leads to a measure of over-equalization and that this is the reason why Ontario would have qualified for payments in recent years if a personal income override had not been added to the formula through Parliamentary approval of Bill C-24. This is a difficult issue on which I would very much like to have the views of the Task Force.

Another issue related to equalization concerns the future treatment of Ontario. Parliament recently approved a bill, the major effect of which was to exclude any province with per capita income regularly above the national average from equalization. This provision applies to Ontario and members of the Task Force may want to consider whether or not this or some similar measure should form part of the 1982-87 fiscal arrangements.

One other issue related to equalization concerns the treatment of local taxation revenues for municipal purposes. Such revenues are not subject to equalization under the existing formula, but local taxation for school purposes are. It has been argued that this discrepancy causes undesirable interaction between the operation of the program and provincial policies in respect of local governments and their financing. The Task Force might also wish to explore this matter.

Interprovincial Fiscal Disparities

One of the issues of most concern to me when I look at the state of government finance in Canada is the high and growing spread of fiscal capacity disparities among provinces. When all forms of taxation are considered, the richest province, Alberta, now has a per capita capacity to raise revenues that is more than four times as large as that of the two poorest provinces - Prince Edward Island and Newfoundland. The disparities have been aggravated in the past few years and are attributable to the very uneven incidence of natural resource wealth among provinces, as well as to the rapid growth in value of such wealth.

If we make the same comparison for natural resource revenues only, we find that the richest province - again Alberta - has more than 100 times the per capita capacity of the two poorest provinces, which in this case are Prince Edward Island and Nova Scotia; and Alberta has more than 50 times the per capita capacity of four other provinces - Ontario, Quebec, Manitoba and New Brunswick. Moreover, the gap is likely to widen further in coming years for, in spite of a widespread impression to the contrary, the National Energy Program does provide for substantial increases in the wellhead price of oil and gas, and these increases will add considerably to the resource revenues of oil- and gas-producing provinces.

I would not be surprised if such wide fiscal disparities among constituent states are unique to Canada. There are, of course, other federations in the world well endowed with natural resources, but to my knowledge none of them has had an experience closely comparable with what we have faced since the mid-1970s.

I would welcome the advice of the Task Force on this issue. I invite you to consider whether we can afford to allow disparities of these kinds to persist and to widen even more in the future. If we did allow them to persist, what would be the impact on the operation of the Canadian economic union? How would their persistence affect the capacity of the federal government to conduct stabilization policies and to implement a policy of balanced economic development in the various parts of the country? How would they affect, in the longer term, the operation of our political system? How would they affect our sense of common nationhood? These are critical questions on which I would welcome the insight of Task Force members. If your view is that something should be done to alleviate these fiscal disparities, I can assure you that I will examine carefully any suggestions you may put forward.

I must tell you that I have looked seriously at the possibility of using the fiscal equalization program to reduce these disparities. But, the fact of the matter is that, while equalization brings about some lessening of fiscal disparities among provinces, it is not designed for this purpose, so that even an enormous increase in federal outlays under the program would have only a limited impact on the relative fiscal position of provincial governments.

A number of Canadian economists, from both Eastern and Western Canada, have suggested a somewhat different approach, which would involve the sharing or "pooling" among provincial governments themselves of a portion of their natural resource revenues. This is a rather novel idea in the Canadian context, where redistribution on a national scale has always been seen to be the responsibility of the federal government. But it would be consistent with the principle of equalization which might soon be entrenched in the Constitution and which would commit the provincial legislatures as well as Parliament. It might also be noted that there is a precedent for a program of this nature, since the revenues of the member states of the Federal Republic of Germany are essentially equalized by means of transfer payments among state governments.

Joint Financing of Health Care Systems

The federal government played a crucial role in the establishment of Canada's public health care programs and is widely perceived as the guardian of national standards in this field. The term "national standards" usually refers to the "program criteria" in the Medical Care Act, namely portability of benefits, comprehensiveness of services, access to those services without excessive user charges, universality of coverage, and public administration. It also refers to the provision of services under "uniform terms and conditions" as required by the agreements pursuant to the Hospital Insurance and Diagnostic Services Act.

In my view, block funding arrangements with suitable and enforceable conditions are an appropriate mechanism for harmonizing programs in the health care field because the programs are well established and the flexibility the provinces enjoy under these arrangements fosters the efficient allocation of resources in the provincial sphere. A return to cost-sharing is always possible but it would not be, in my judgement, of any obvious advantage to either the federal government or the provinces.

One issue which has arisen recently is whether or not the flexibility which the provinces have under block-funding is compatible with the maintenance of national standards. I suggest that important policy objectives of the federal government in the field of health care might be to confirm explicit acceptance by provinces of the national standards embodied in existing or new federal legislation, and to develop an effective mechanism to ensure that they are complied with.

Federal Support for Education

The post-secondary education component of EPF is classified as a social policy transfer, but to the extent that it serves federal policy goals, it is mainly related to long-term economic development. The existence of a large number of highly qualified managers, professionals and technicians is essential for future development. It is also in the university atmosphere that a good deal of the research which generates scientific advance, invention and industrial innovation takes place. However, the program as it now exists provides no link between these obvious federal policy interests and provincial outlays financed by these transfers.

The Task Force will want to consider what changes, if any, in the present arrangements should be considered.

6. FISCAL ARRANGEMENTS AND THE GOVERNMENT'S BUDGET STRATEGY

In view of the fact that the mandate of the Task Force specifies that its examination of fiscal arrangements "take place within the context of the government's expenditure plan as set out in the October 28, 1980 budget", I would like to emphasize the importance of the review of these arrangements for successful implementation of the budget strategy in 1982-83 and the following fiscal years. You will recall that we are committed to maintaining expenditures within the rate of growth of the economy. My judgement was, at the time of the budget, that significant savings would have to be achieved in transfer payments to provincial governments which are part of the social affairs envelope, if we were to implement our overall strategy, particularly with regard to deficit reduction and the shift of our spending

priorities towards economic development. I am still very much of that view. If anything, the recent aggravation of inflationary pressures has made it even more important that we achieve our stated objective in this regard. I also confirmed to the House on February 25 that, as provided in budget projections, we expect to secure net savings of the order of $1.5 billion in 1982-83 and 1983-84.

7. THE FUNDAMENTAL ISSUE: FISCAL BALANCE

I would like to conclude by drawing your attention to one issue which I expect to remain at the forefront throughout your deliberations. You are likely to hear about it from coast to coast. It is what I would call the fundamental issue: fiscal balance.

Because the federal government is opposed to the sort of "checker board federalism" which could result from certain forms of decentralism, it is often portrayed as favouring the opposite extreme. But this sort of caricature is both unfounded and unfair. It is certainly not my view.

I recognize that striking an appropriate balance between these opposing tendencies is not always easy. And I recognize that some tension between the two orders of government in Canada is inevitable. However, I believe that both the federal and provincial governments have essential and complementary roles to play. And that with goodwill and imagination we will be able to work out mutually acceptable arrangements which will benefit all Canadians.

You have a difficult but challenging task. I wish you well and look forward to your report.

SUPPLEMENTARY MATERIAL ON FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS

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ANNEX I

PRINCIPLES OF FISCAL FEDERALISM

The basic principles which underlie the fiscal relations between the federal and provincial governments have been enunciated on a number of occasions over the past two decades. While the emphasis placed on one or more of these principles may vary over time, all of the principles are important.

Perhaps one of the most succinct statements of the principles underlying federal-provincial fiscal relations in Canada was given by former Minister of Finance Mitchell Sharp at the meeting of the Federal-Provincial Tax Structure Committee in September 1966. Mr. Sharp set forth the following guiding principles:

(1) "The fiscal arrangements should give both the federal and provincial governments access to fiscal resources sufficient to discharge their responsibilities under the constitution.

(2) "They should provide that each government should be accountable to its own electors for its taxing and spending decisions and should make these decisions with due regard for their effect on other governments.

(3) "The fiscal arrangements should, through a system of equalization grants, enable each province to provide an adequate level of public services without resorting to rates of taxation substantially higher than those of other provinces.

(4) "They should give to the Federal Government sufficient fiscal power to discharge its economic and monetary responsibilities, as well as to pay its bills. In particular they should retain for the Federal Government a sufficient part of the income tax field in all provinces - both personal and corporate - to enable it to use variations in the weight and form of that tax for economic purposes and to achieve a reasonable degree of equity in the incidence of taxation across Canada.

(5) "They should lead to uniform intergovernmental arrangements and the uniform application of federal laws in all provinces.

(6) "The fiscal arrangements should seek to provide machinery for harmonizing the policies and the priorities of the federal and provincial governments."

The first principle is to ensure that each government has access to sufficient financial resources to be able to discharge its responsibilities. Whether each order of government has adequate access has been the subject of some debate over the years. The second principle is essentially the principle of "fiscal responsibility" - a fundamental principle of public finance. The third principle relates to equalization. The importance attached to this program is indicated by Part III of the Proposed Resolution respecting the Constitution of Canada.

The fourth principle seeks to ensure that the federal government has sufficient control over the personal and corporate income tax fields to use these to achieve economic objectives. At the time Mr. Sharp enunciated his principles, the provinces were arguing that the federal government should cede portions of these taxes to the provinces since provincial expenditures were growing at a very rapid rate relative to the growth in the yield of their tax systems. It was pointed out to provinces that if they wished to increase their yield from the income tax system they should simply increase their rates, as all provinces were free to do under the tax collection arrangements which began in 1962. In order to increase their freedom to do so, the government indicated its intention to discontinue the abatement system in the personal income tax which, provinces argued, constituted an impediment to action by them to raise their rates of tax.

The fifth principle is that the fiscal relations between the federal and each provincial government should be uniform and that there should be no special arrangements for particular provinces. Prior to this, of course, the contracting out arrangement with the province of Quebec had come into effect. This arrangement gave rise to confusion in the minds of some people that Quebec was enjoying a financial advantage over other provinces. If the fiscal arrangements with all provinces were identical, then such misunderstanding would not arise. This resulted in a renewed offer by the federal government to permit all provinces to contract out of major shared-cost programs. This offer was subsequently dropped when no province expressed interest in the proposal.

The sixth principle is that the fiscal arrangements should facilitate the harmonization of fiscal policies by the federal and provincial governments and should not promote disharmony in the income tax system. The Conference of Finance Ministers whose original purpose was to negotiate the fiscal arrangements has evolved over the past fifteen years into a regular forum for discussion of fiscal policies. The annual pre-budget meeting to discuss the economic outlook and the fiscal and borrowing position of all governments is preceded by considerable preparatory work by officials.

The principles enunciated by Mr. Sharp were reiterated by former Minister of Finance Edgar Benson at the Federal-Provincial Conference of Ministers of Finance and Provincial Treasurers in November 1968. At that time Mr. Benson stated that "these principles bear repeating since they remain the basis of our policy today".

In his speech on second reading of the Federal-Provincial Fiscal Arrangements Act, 1972, former Finance Minister John Turner stated that the provisions of the legislation are "based on the concepts of fiscal independence and fiscal responsibility of each of our eleven sovereign governments. In this regard they aim at a balance between centralization and decentralization of public finances in Canada."

Subsequently, at a Federal-Provincial Meeting of Ministers of Finance and Provincial Treasurers, in January 1974, Mr. Turner stated the following in reference to the tax-sharing arrangements:

> "Our system rests upon three fundamental principles.
>
> "First, the principle of responsibility, which says that each government should take responsibility with its own electorate for raising the revenues which are necessary to finance its own programs.
>
> "Second, the principle of access, which assures to each level of government full constitutional power to raise revenues from each of the major revenue sources available to government.
>
> "Third, the principle of interprovincial equality, which makes the principle of access real and meaningful by providing equalization payments to provinces whose capacity to raise revenues from their own sources is below the per capita average of all provinces."

At another Federal-Provincial Meeting of Ministers of Finance and Provincial Treasurers, in December 1974, Mr. Turner addressed the issue of the federal administration of provincial tax credits under the Tax Collection Agreements. Mr. Turner stated the following:

> "In thinking about these matters I have come to the conclusion that where it is possible to permit provincial income tax systems to depart from strict conformity with the criteria we have previously insisted upon without distorting and damaging the over-all national system, I would be prepared to do so. This does not mean that I no longer consider the essential harmony of the federal and provincial tax systems as necessary. I certainly

do. It simply means that we can now begin to consider relaxing the earlier conditions we insisted on in the tax collection agreement provided, in doing so, we do not jeopardize the main features of our tax system or overstrain the tolerance of taxpayers or the capacity of the tax collecting apparatus."

In launching discussions of the fiscal arrangements for the 1977-82 period in April 1976, former Finance Minister Donald MacDonald referred to the six principles articulated by Mr. Sharp ten years earlier and indicated that "we believe these principles are still valid and should be preserved".

As the statements by former Ministers of Finance over the past fifteen years make clear, there has been continuity in the federal position on the principles underlying the fiscal arrangements in Canada.

In addition to considering the current arrangements in light of the traditional principles upon which the fiscal arrangements have been based, a number of specific objectives of the federal government should be kept in mind.

The fiscal arrangements should facilitate implementation of the government's expenditure policy during the five-year period from 1982-83 to 1986-87. Generally, this policy requires that the growth of total federal spending be held within the trend growth of GNP. However this does not mean that intergovernmental transfers, or any particular category of outlays, should necessarily be held to the trend line. Indeed as the Minister of Finance indicated in the Budget of October 28, 1980, the rate of growth of intergovernmental transfers would have to be reduced in order to accommodate other government priorities within the fiscal framework.

The fiscal arrangements should provide for greater flexibility in federal budget planning. This is one of the basic objectives of the new expenditure planning system. The capacity of the federal government to launch new programs in pursuit of its policy objectives is likely to remain severely constrained unless revisions in existing programs free up resources and increase the government's margin of manoeuvre. There is no valid reason why intergovernmental transfers should be exempted a priori from this ongoing exercise in resource reallocation.

The fiscal arrangements should continue to provide provincial governments with stable and predictable sources of revenue. Federal cash and tax transfers finance a significant proportion of total provincial revenues. Their predictability is therefore an important factor in provincial budget planning, particularly for provinces with below average fiscal capacity.

From the federal perspective, of course, stability for provincial Treasuries should not lead to undue rigidity in federal fiscal management. Some middle ground is therefore necessary between a virtually ironclad assurance of escalated payments to provinces and uncertainty as to what funds they may expect from the federal government from one fiscal year to the next.

During the constitutional discussions last summer, the federal government attempted to negotiate constitutional provisions to strengthen the Canadian economic union. More specifically the federal government wanted to include in the Constitution the following principle:

> "governments cannot in their legislation and practice discriminate on the basis of the province of residence for persons or on the basis of the province of origin or destination for goods, services and capital."

The question was the subject of long and arduous discussions with the provinces. While most provinces at the end accepted the idea of entrenching the principle of the Canadian economic union in a revised constitution, they generally rejected the proposal that the principle should be enforceable through the courts. Provinces, led by Saskatchewan, would have preferred a political mechanism which could have ruled on derogations to the principle of economic union. The Premier of Saskatchewan suggested that governments could be guided by a generally agreed "code of acceptable practices". The strengthening of the economic union through negotiation and implementation of such a code is an issue which the Committee might well consider.

The fiscal arrangements should also ensure that Canadians are better informed of the massive contribution the federal government makes to economic and social development in all parts of Canada through intergovernmental transfers to provincial governments and, indirectly, to local administrations. There is an obvious need for more effective information programs in this area. It would be desirable for provincial governments to share the responsibility of informing the public of federal contributions to provincial programs.

ANNEX II

OVERVIEW OF FEDERAL TRANSFERS TO PROVINCES AND OTHER FEDERAL-PROVINCIAL FINANCIAL LINKS

This annex presents background information of a general nature on intergovernmental transfers and other federal-provincial financial links. Historical and current data on the major transfers are included, along with data on the importance of transfers in federal and provincial expenditures. Trends in Canadian fiscal federalism relevant to an examination of intergovernmental transfers are reviewed. These trends raise the issue of federal-provincial fiscal balance and data relevant to that issue, namely on federal and provincial surpluses and deficits, are presented. Finally, federal-provincial financial links other than transfers are noted.

Intergovernmental Transfers

Federal transfers to provinces can be classified according to their purpose, the way they are calculated, and the form they take. Their purpose can be either to provide general financial assistance to provinces, in which case they are "unconditional", or to provide earmarked assistance for specific policy areas or programs, in which case they are "conditional". The federal contribution may be tied to provincial expenditures on the basis of a cost-sharing formula, in which case the transfer is "shared-cost", or it may be calculated in some other way, e.g. it is related to a measure of fiscal need, the growth of the economy, or other socio-economic indicators, in which case the transfer is a "block-fund". Finally, transfers can take the form of cash payments, of tax transfers, or of a combination of both.

Cash transfers simply consist of regular payments by cheque to the provinces. A few words of explanation may be helpful, however, on tax transfers. A tax transfer is simply a means whereby the federal government shifts to provincial governments a certain amount of tax room. A tax transfer takes place at a specific point in time: the federal government reduces its tax rates and the provinces increase their rates commensurately. The federal government is able to compute accurately in subsequent years the value of the tax revenue forgone as a result of the tax transfer, and to adjust cash payments to the provinces, if necessary, by taking into account the value of the tax transfer. An example of a tax transfer is provided by the contracting-out arrangements with the province of Quebec. These are described later in this section.

Table II-1 summarizes federal transfers to provinces over the post-war period. Total cash plus tax transfers to provinces will amount to $18.5 billion in 1981-82. This compares with just over $5 billion one decade ago, and considerably less than $1 billion two decades ago. (The tax rental payments in respect of the personal and corporate income taxes were replaced in 1962-63 by the Income Tax Collection Agreements. The tax transfer which took place in 1962-63 as a result, and which was subsequently increased, is not reflected in the tax transfer block of Table II-1.) Table II-2 presents more detail, on a province-by-province basis, of the cash and tax transfers for the fiscal year 1981-82.

The major unconditional transfer is the fiscal equalization payment. That is discussed in more detail in Annex V. It is sufficient here to note that the purpose of the Fiscal Equalization program is to enable all provincial governments to provide a reasonable level of public services without having to resort to unduly high rates of taxation. Other unconditional programs include the statutory subsidies which are the original grants to provinces established at the time of Confederation and augmented by various increases in the years following Confederation. Another unconditional grant program is the transfer to provincial governments under the Public Utilities Income Tax Transfer Act. Under this Act, the federal government transfers to provincial governments 95 per cent of the corporate income tax paid by privately owned utilities in the province.

A major unconditional grant program which was instituted following tax reform in 1972 was the Provincial Revenue Guarantee program. As Table II-1 indicates, the federal government paid to the provinces over $2.7 billion under this program. These payments were in respect of the years 1972-73 to 1976-77, although the actual payments, due to lags in availability of data, stretched out until 1979-80.

Table II-1 also includes cash transfers under two programs which serve tax harmonization purposes. These are the grants to provincial governments in respect of consumption taxes under the Reciprocal Taxation Agreements, and the grants in lieu of property taxes to municipal and (in some cases) provincial governments.

Conditional grants may be used by the federal government to ensure that programs are introduced on a national basis and achieve a degree of harmony from province to province even though the constitutional responsibility for such programs rests mainly with the provinces. By contributing to the financing of these programs, the federal government ensures that all citizens of the country are entitled to comparable benefits. A major justification for conditional grants of

TABLE II-1

FEDERAL TRANSFERS TO THE PROVINCES AND MUNICIPALITIES
1947-48 TO 1981-82
($ Millions)

Fiscal Year	Cash Payments															Tax Transfers					Tax Rental Payments
	Statutory Subsidies	Equalization	Revenue Guarantee	Reciprocal Taxation	PUITTA	Municipal Grants	Hospital Insurance	Medicare	Extended Health Care	Vocational Training	University Grants	Post-Secondary Education	Welfare Including CAP	Other Cash Payments	Total Cash Payments	Contracting Cut	Post-Secondary Education	Established Programs Financing	Total Tax Transfers	Total Cash Plus Tax Transfers	
1947-48	17.1	-	-	-	2.9	-	-	-	-	-	-	-	59.1	11.3	90.4	-	-	-	-	90.4	112.5
1948-49	17.1	-	-	-	3.7	-	-	-	-	-	-	-	66.8	22.0	109.6	-	-	-	-	109.6	84.4
1949-50	25.7	-	-	-	1.4	.4	-	-	-	4.7	-	-	90.8	20.2	143.2	-	-	-	-	143.2	76.9
1950-51	25.2	-	-	-	4.6	1.4	-	-	-	4.1	-	-	103.6	41.8	180.7	-	-	-	-	180.7	94.1
1951-52	26.6	-	-	-	3.7	2.0	-	-	-	4.2	7.0	-	84.5	40.9	168.9	-	-	-	-	168.9	96.9
1952-53	25.8	-	-	-	4.4	2.5	-	-	-	4.9	5.1	-	22.2	43.9	108.7	-	-	-	-	108.7	308.6
1953-54	24.9	-	-	-	6.8	3.4	-	-	-	4.4	5.2	-	23.2	47.6	115.5	-	-	-	-	115.5	309.2
1954-55	24.3	-	-	-	7.3	3.4	-	-	-	4.4	5.4	-	24.1	54.5	123.5	-	-	-	-	123.5	327.4
1955-56	23.4	-	-	-	7.9	7.2	-	-	-	4.3	5.5	-	29.5	55.3	133.1	-	-	-	-	133.1	319.6
1956-57	22.8	-	-	-	6.6	9.7	-	-	-	4.7	16.0	-	38.4	68.0	166.2	-	-	-	-	166.2	365.9
1957-58	22.0	136.0	-	-	7.4	17.5	-	-	-	4.8	16.6	-	48.1	95.4	347.8	-	-	-	-	347.8	213.9
1958-59	35.2	168.4	-	-	8.7	21.9	54.7	-	-	8.1	25.5	-	74.1	117.2	513.8	-	-	-	-	513.8	249.0
1959-60	28.7	208.0	-	-	4.8	22.6	150.6	-	-	8.4	26.1	-	90.9	130.6	670.7	-	-	-	-	670.7	279.7
1960-61	28.7	214.0	-	-	4.2	24.6	188.9	-	-	8.7	19.0	-	102.8	137.4	728.3	7.7	-	-	7.7	736.0	288.7
1961-62	31.5	189.7	-	-	6.4	24.9	283.2	-	-	35.9	19.4	-	143.5	147.0	881.5	7.9	-	-	7.9	889.4	312.6
1962-63	31.5	211.6	-	-	10.0	29.4	335.8	-	-	207.5	26.3	-	159.5	139.8	1,151.4	10.7	-	-	10.7	1,162.1	25.7
1963-64	31.6	202.4	-	-	9.9	31.7	391.3	-	-	136.5	26.8	-	172.2	160.7	1,163.1	10.9	-	-	10.9	1,174.0	10.5
1964-65	31.6	261.6	-	-	9.7	36.2	433.0	-	-	97.2	27.3	-	182.4	229.3	1,308.3	11.1	-	-	11.1	1,319.4	40.9
1965-66	31.6	310.0	-	-	6.4	37.1	354.5	-	-	158.9	27.7	-	153.4	271.5	1,351.1	224.0	-	-	224.0	1,575.1	43.7
1966-67	31.6	370.5	-	-	6.0	38.4	383.7	-	-	232.3	70.9	-	189.7	317.4	1,640.5	294.9	-	-	294.9	1,935.4	54.0
1967-68	31.7	547.6	-	-	6.7	40.8	435.1	-	-	193.1	-	108.0	342.6	283.2	1,988.8	333.6	227.6	-	561.2	2,550.0	55.4
1968-69	31.7	566.1	-	-	20.8	44.3	550.3	33.0	-	-	-	276.6	382.8	324.1	2,229.7	336.9	247.0	-	583.9	2,813.6	59.7
1969-70	31.8	683.3	-	-	23.6	49.5	624.9	181.0	-	-	-	301.4	395.6	293.2	2,584.3	400.4	307.0	-	707.4	3,291.7	59.9
1970-71	31.8	899.2	-	-	23.9	52.2	688.1	400.5	-	-	-	388.3	518.7	458.9	3,461.6	473.3	341.3	-	814.6	4,276.2	63.5
1971-72	33.8	1,049.6	-	-	24.3	55.4	823.5	575.5	-	-	-	450.5	624.3	544.5	4,181.4	531.7	398.5	-	930.2	5,111.6	65.9
1972-73	33.7	1,176.8	-	-	80.0	61.8	1,019.5	629.2	-	-	-	481.1	677.6	275.5	4,435.2	442.3	468.9	-	911.2	5,346.4	12.4
1973-74	33.8	1,500.1	42.6	-	25.9	62.7	1,073.2	676.2	-	-	-	485.1	717.6	454.5	5,071.7	543.4	581.1	-	1,124.5	6,196.2	.1
1974-75	33.8	1,795.0	475.2	-	26.7	68.2	1,360.3	760.8	-	-	-	503.6	976.3	488.3	6,488.2	742.5	708.2	-	1,450.7	7,938.9	3.7
1975-76	33.8	1,956.5	460.5	-	31.8	76.0	1,754.7	793.8	-	-	-	535.0	1,279.2	461.7	7,383.0	913.5	855.4	-	1,768.9	9,151.9	-1.1
1976-77	33.8	2,169.3	943.1	-	38.5	88.5	2,007.2	1,001.0	-	-	-	648.7	1,490.0	592.4	9,012.5	1,067.3	904.1	-	1,971.4	10,983.9	-4.9
1977-78	34.0	2,521.2	600.4	46.7	45.9	117.0	1,754.0	596.4	464.5	-	-	1,095.5	1,396.2	706.4	9,378.2	664.4	-	2,698.1	3,362.5	12,740.7	-
1978-79	34.0	2,632.4	121.6	100.4	81.8	130.8	2,252.7	715.4	520.3	-	-	1,365.4	1,523.4	757.1	10,235.3	729.9	-	2,909.6	3,639.5	13,874.8	-
1979-80	34.1	3,309.6	72.1	105.3	66.3	127.6	2,385.4	814.7	576.8	-	-	1,489.5	1,646.2	850.5	11,478.1	829.9	-	3,280.0	4,109.9	15,588.0	-
1980-81	34.1	3,313.7	-	107.3	64.3	153.7	2,582.1	886.6	639.4	-	-	1,621.0	1,893.8	705.2	12,001.2	905.8	-	3,674.5	4,580.3	16,581.5	-
1981-82	35.6	3,627.7	-	131.9	78.9	165.7	2,861.0	985.0	709.1	-	-	1,820.2	1,984.4	1,007.8	13,406.8	1,012.4	-	4,072.7	5,085.1	18,491.9	-

Source: Public Accounts of Canada (1947-48 to 1979-80), Main Estimates (1980-81 and 1981-82) and Department of Finance data.

TABLE II-2

ESTIMATED FEDERAL TRANSFERS TO THE PROVINCES, TERRITORIES AND MUNICIPALITIES FOR 1981-82
(in millions of dollars)

Program	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	N.W.T.	Yukon	Total
Statutory Subsidies	9.8	.7	2.3	1.8	4.6	6.0	2.2	2.2	3.5	2.5	–	–	35.6
Fiscal Equalization	416.7	95.6	488.5	418.7	1,842.4	–	365.3	–	–	–	–	–	3,627.2
1971 Undistributed Income on Hand	*	–	*	–	3.4	.4	*	*	.3	.1	–	–	4.2
Reciprocal Taxation	9.3	2.9	18.7	8.5	35.0	57.5	–	–	–	–	–	–	131.9
Public Utilities Income Tax Transfer	4.7	.8	–	–	1.4	21.6	2.0	*	36.9	1.5	.3	.3	79.5
Youth Allowances Recovery	–	–	–	–	-179.6	–	–	–	–	–	–	–	-179.6
Prior Year Adjustments**													200.0
Total Fiscal Transfer Cash Payments	440.5	100.0	509.5	429.0	1,707.2	85.5	369.5	2.2	40.7	4.1	.3	.3	3,898.8
Hospital Insurance	79.7	17.2	117.1	97.5	592.2	1,103.0	140.8	133.7	249.8	330.0	5.7	2.4	2,869.1
Medicare	27.4	5.9	40.3	33.6	203.9	379.8	48.5	46.0	86.0	113.6	2.0	.8	987.8
Post-Secondary Education	50.7	10.9	74.5	62.0	376.8	701.8	89.6	85.0	159.0	209.9	3.6	1.6	1,825.4
Extended Health Care	17.2	3.7	25.3	21.1	186.3	254.8	30.5	28.9	62.8	78.5	1.3	.6	711.0
Prior Year Adjustments**													18.0
Established Programs Financing Cash Payments	175.0	37.7	257.2	214.2	1,359.2	2,439.4	309.4	293.6	557.6	732.0	12.6	5.4	6,411.3
Canada Assistance Plan	56.3	13.0	72.7	79.0	572.3	553.4	72.2	75.3	167.0	323.2	8.9	2.1	1,995.4
Health Resources Fund	–	.2	1.5	–	3.2	.9	–	–	–	.2	–	–	6.0
Other Health and Welfare	1.0	.5	2.4	4.5	–	33.1	5.5	5.2	9.2	4.0	.1	1.4	66.9
Bilingualism in Education	1.5	.7	2.6	13.4	108.2	41.2	4.0	1.4	3.8	4.3	.1	.1	181.3
Economic Development	54.0	28.9	62.9	75.3	218.3	54.5	42.0	29.2	13.7	34.9	5.0	2.9	621.6
Crop Insurance	*	.9	.2	.2	3.8	13.7	9.8	41.3	27.4	1.7	–	–	99.0
Territorial Financial Agreements	–	–	–	–	–	–	–	–	–	–	273.6	62.1	335.7
Municipal Grants	1.7	.7	9.2	5.0	32.7	75.6	10.1	4.2	9.7	16.8	.8	1.3	167.8
Total Other Cash Payments	114.5	44.9	151.5	177.4	938.5	772.4	143.6	156.6	230.8	385.1	288.5	69.9	3,473.7
TOTAL CASH TRANSFERS	730.0	182.6	918.2	820.6	4,004.9	3,297.3	822.5	452.4	829.1	1,121.2	301.4	75.6	13,783.8
Established Programs Financing Tax Transfer													
13.5 Personal Income Tax Points	49.5	10.7	94.0	69.9	931.2	1,502.7	132.2	122.6	381.8	480.6	7.3	5.1	3,787.6
1.0 Corporate Income Tax Point	2.9	.5	5.6	3.7	58.6	109.9	9.6	11.3	59.9	35.5	.7	.3	298.5
Contracting-Out Tax Transfer													
8.5 Personal Income Tax Points for EPF	–	–	–	–	532.7	–	–	–	–	–	–	–	532.7
5.0 Personal Income Tax Points for CAP	–	–	–	–	300.1	–	–	–	–	–	–	–	300.1
3.0 Personal Income Tax Points for Youth Allowance	–	–	–	–	179.6	–	–	–	–	–	–	–	179.6
TOTAL TAX TRANSFERS	52.4	11.2	99.6	73.6	2,002.2	1,612.6	141.8	133.9	441.7	516.1	8.0	5.4	5,098.5
TOTAL CASH PLUS TAX TRANSFERS	782.4	193.8	1,017.8	894.2	6,007.1	4,909.9	964.3	586.3	1,270.8	1,637.3	309.4	81.0	18,882.3
Fiscal Equalization – Dollars per capita	712	765	569	588	291	–	355	–	–	–	–	–	

* Amount too small to be expressed
** Distribution not available.

this nature is that with significant mobility of persons among provinces, there are good reasons, both economic and political, to share on a broader basis at least part of the cost of basic social welfare, health and education programs, and to ensure that these meet minimum national standards. Originally, shared-cost programs were established in these three areas, but they were replaced by the Established Programs Financing arrangements in the case of health and education. The major remaining shared-cost program is the Canada Assistance Plan, under which the federal government pays 50 per cent of eligible provincial expenditures for income maintenance and social services.

Under the Established Programs Financing arrangements, the federal government makes an equal per capita contribution towards the financing of hospital care, medical care and post-secondary education expenditures in all provinces. Its contribution is determined, not in accordance with program expenditures by province (as under conventional shared-cost arrangements) but rather on the basis of expenditures in a base year (1975-76) escalated by the rate of growth of the economy. The purpose of these arrangements is to provide provinces with more flexibility with respect to programs which are "established". However, provinces are still obliged to maintain national standards (portability, accessibility, universality, comprehensiveness and public administration) under the hospital care and medical care programs. It should be noted that no conditions are attached to the post-secondary component. The Established Programs Financing arrangements, which were introduced in 1977-78, are discussed in more detail in Annex VI.

Finally, under the contracting-out arrangements, the Quebec taxpayer reduces his federal basic tax by 16.5 per cent. Instead of paying, say $100, as he would if he were a resident of any other province, he pays only $83.50. The value of the revenue forgone by the federal government in Quebec is used to reduce cash amounts otherwise payable by the federal government to the province. The province, for its part, occupies the "tax room" made available by this special abatement, and so collects additional taxes under its own system.

Weight of Transfers in Federal Expenditures

Intergovernmental transfers are a very important component of the federal budget. Cash transfers account for over 20 per cent of total federal expenditures, while tax transfers reduce federal revenues by about 7 per cent.

The growth of federal transfers to provinces over the post-war period was presented in Table II-1 above. However, in order to gain some perspective on this growth, it is instructive to consider transfers to other governments as a percentage of total federal expenditures. Table II-3

presents the percentage distribution of federal government expenditures by economic function, on a National Accounts basis, for the past two decades. It is important to note that Table II-3 does not reflect the tax transfers to provinces which have taken place during the same period.

Perhaps the most interesting column of Table II-3 is the first one, which indicates that federal government expenditures on goods and services have decreased continuously from about 36 per cent of total expenditures in 1960 to less than 25 per cent by the end of the 1970s. Transfers to persons have remained constant over the past two decades at about 28-29 per cent of total government expenditures. Interest on the public debt was also constant at around 11 per cent until recent years. The rapid increase in the deficit in the last few years has of course increased the proportion of total expenditures devoted to interest on the public debt.

TABLE II-3

FEDERAL GOVERNMENT EXPENDITURES
PERCENTAGE DISTRIBUTION BY ECONOMIC FUNCTION
1960 to 1980

Year	Goods and Services	Transfers to Persons	Interest on Public Debt	Transfers to Other Levels of Government	Other	Total
1960	36.0	29.2	11.2	14.7	8.9	100.0
1961	36.0	27.9	10.9	15.7	9.5	100.0
1962	35.9	28.2	11.6	15.1	9.2	100.0
1963	34.4	28.0	12.3	15.4	9.9	100.0
1964	34.3	28.0	12.4	15.6	9.7	100.0
1965	33.1	27.0	12.3	16.7	10.9	100.0
1966	33.5	25.5	11.8	17.1	12.1	100.0
1967	32.4	26.6	11.3	18.1	11.6	100.0
1968	31.8	26.9	11.5	19.4	10.4	100.0
1969	31.5	26.7	11.8	20.2	9.8	100.0
1970	29.8	26.6	12.2	22.3	9.1	100.0
1971	28.5	26.9	11.4	24.9	8.3	100.0
1972	27.1	30.7	11.2	22.6	8.4	100.0
1973	27.1	31.3	11.2	21.4	9.0	100.0
1974	25.7	30.2	10.3	21.4	12.4	100.0
1975	23.5	29.9	10.4	21.6	14.6	100.0
1976	24.9	29.7	11.6	22.0	11.8	100.0
1977	25.4	29.9	11.6	22.7	10.4	100.0
1978	24.5	29.9	13.1	22.2	10.3	100.0
1979	23.9	27.8	15.4	22.3	10.6	100.0
1980	22.4	27.2	15.8	21.1	13.5	100.0

Source: Statistics Canada, National Income and Expenditure Accounts.

The evolution of transfers to other levels of government suggests that there have been two distinct phases over the past two decades. During the 1960's there was a steady increase in transfers to other levels of government as a percentage of total expenditures from around 15 per cent to over 20 per cent. During the 1960s major shared-cost programs such as hospital insurance, medical care and post-secondary education assistance were introduced. There were also substantial increases in equalization payments during the 1967-68 to 1971-72 period (see Table II-1). During the 1970s, transfers to other levels of government have been relatively constant at between 22 per cent and 23 per cent of total federal expenditures.

Weight of Transfers in Provincial Revenues

As shown in Table II-4, intergovernmental transfers are a vitally important source of revenues for all provinces, particularly the Atlantic provinces where they accounted for over 50 per cent of revenues from all sources in 1980-81. They made up that same fiscal year over 40 per cent of Manitoba's revenues, over one-third of Quebec's, 20-25 per cent of the revenues of Ontario, British Columbia and Saskatchewan, and over 10 per cent of those of Alberta. Table II-4 also indicates the importance of federal transfers to each province in per capita terms.

TABLE II-4

SIGNIFICANCE OF INTERGOVERNMENTAL TRANSFERS

1980-81

Prov.	Gross General Revenues	Federal Transfers Cash	Federal Transfers Tax	Federal Transfers Total	Transfers as % of Revenues	Transfers Per Capita
	$ millions				%	$
Nfld.	1,472	706	47	753	51.2	1,298
P.E.I.	306	161	10	171	55.9	1,379
N.S.	1,867	897	89	986	52.8	1,156
N.B.	1,584	741	65	806	50.9	1,140
Que.	16,098	3,881	1,787	5,668	35.2	899
Ont.	17,033	2,951	1,436	4,387	25.8	512
Man.	2,230	791	126	917	41.1	892
Sask.	2,619	421	119	540	20.6	557
Alta.	9,546	731	394	1,125	11.8	541
B.C.	6,324	1,085	459	1,544	24.4	586
Total	59,080	12,365	4,532	16,897	28.6	708

Source: Department of Finance.

General Trends in Canadian Public Finance

As noted in the Submission, there have been profound changes in the Canadian system of public finance since 1867, but particularly since the 1950s. For purposes of examining federal-provincial fiscal relations, the most relevant background data relate to changes in the relative federal and provincial-local shares of total public-sector revenues and expenditures. Table II-5 indicates that, from 1960 to 1980, the federal share of total revenues before transfers declined from 58 to 47 per cent, while the provincial-local share increased from 42 to 53 per cent. If federal tranfers to provinces are included in provincial revenues, the federal share of total revenues declined over the same period from over one-half to about one-third, while the provincial-local share increased from less than one-half to nearly two-thirds. Chart II-1 illustrates these changes graphically. It also illustrates the same trends, while less marked, on the expenditure side.

The same trends can be observed by looking at changes in federal and provincial-local expenditures as shares of Gross National Product. This is displayed in Chart II-2.

TABLE II-5

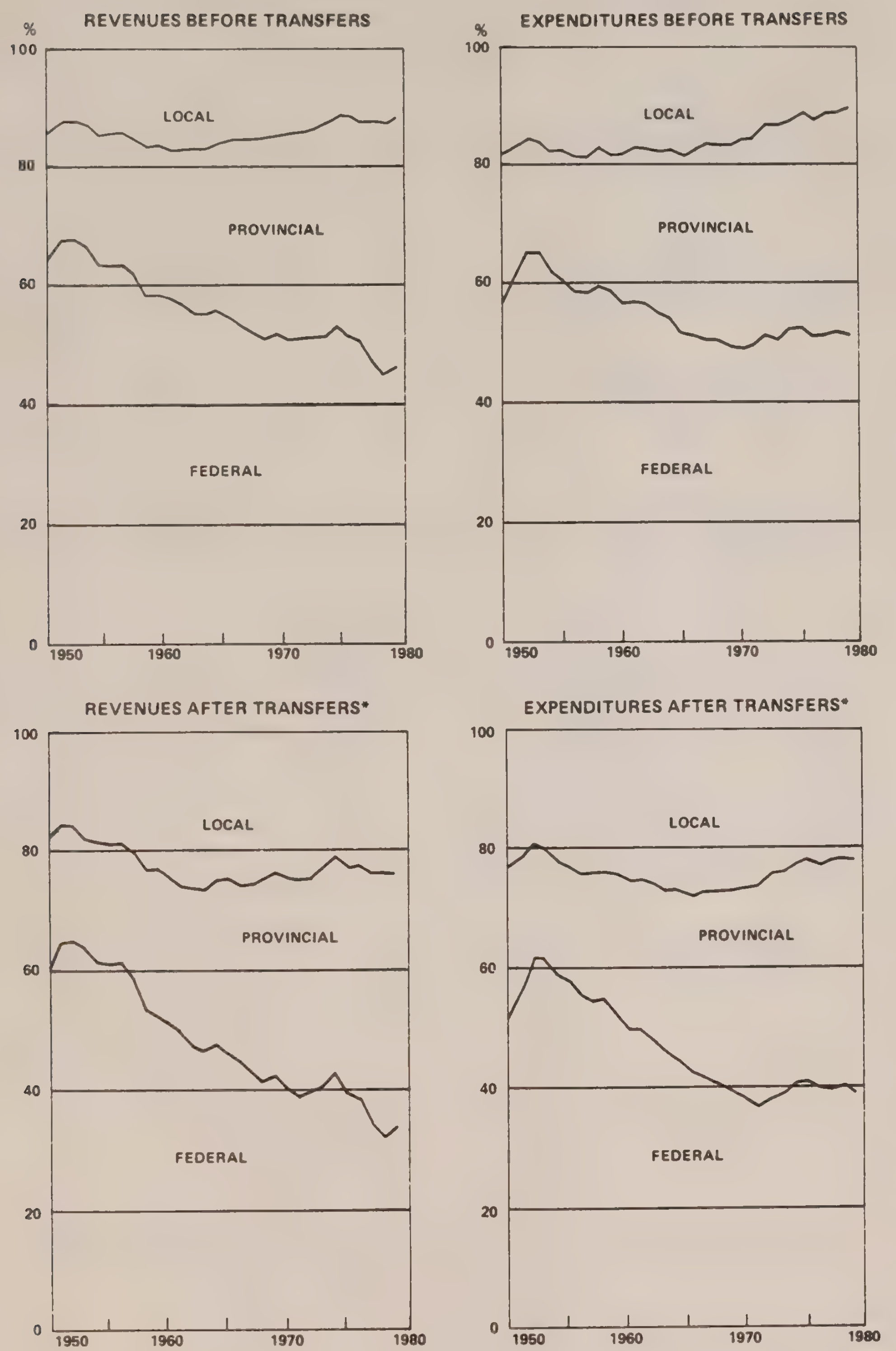
FEDERAL-PROVINCIAL REVENUE SHARING

	$ billions		% Share	
	1960	1980	1960	1980
Own Source Revenues				
Federal	6.2	50.1	58	47
Provincial-local	4.5	57.4	42	53
Total	10.7	107.5	100	100
Federal Transfers to Provinces	0.7	12.5	-	-
Revenues after Transfers				
Federal	5.5	37.3	52	35
Provincial-local	5.2	70.2	48	65
Total	10.7	107.5	100	100

Source: Statistics Canada, *National Income and Expenditure Accounts*.

CHART II-1

REVENUES AND EXPENDITURES BY LEVEL OF GOVERNMENT

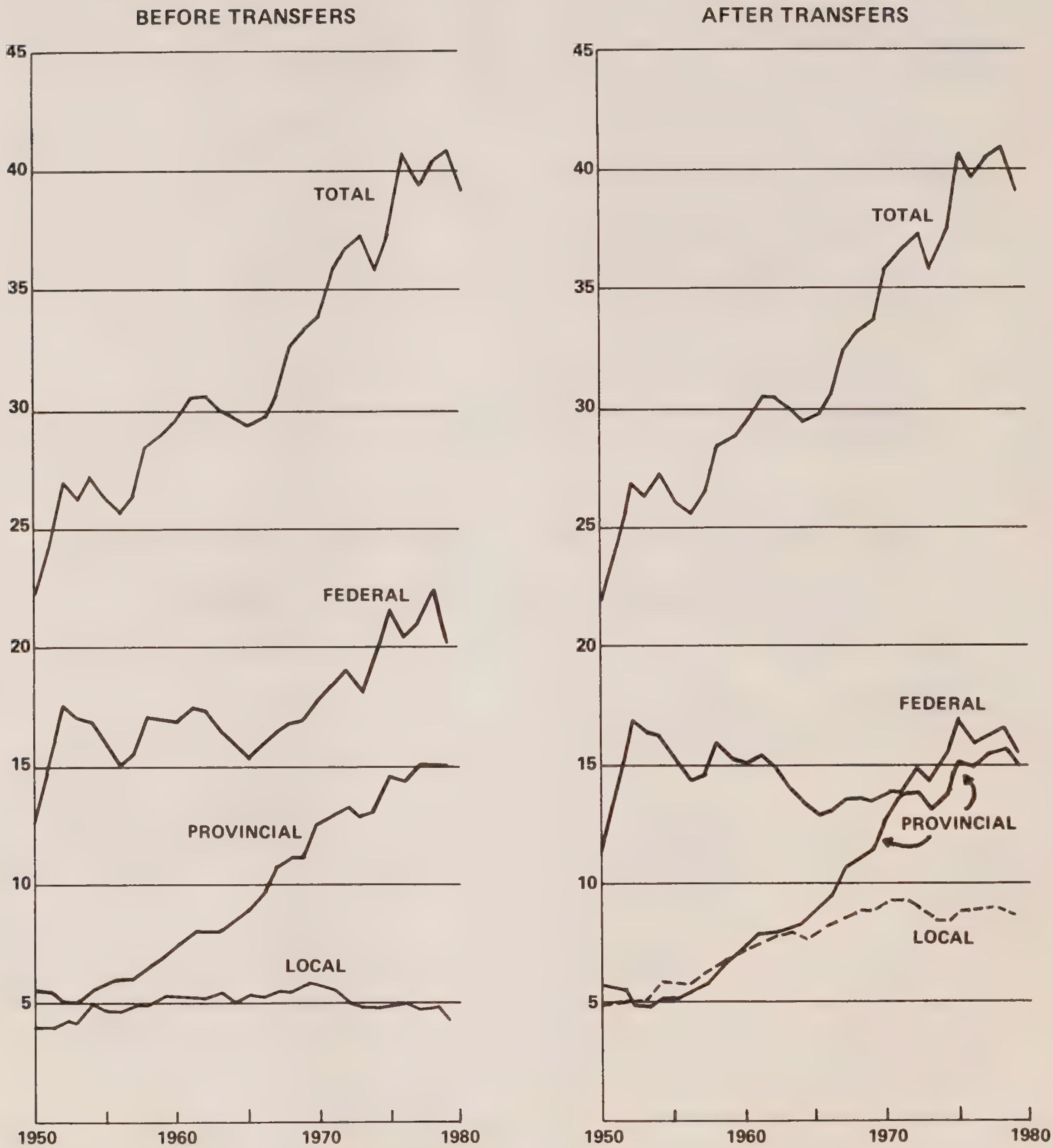


* Transfers between levels of government are substracted from the revenues/expenditures of the governments which pay and added to the revenues/expenditures of recipient governments.

Source: Statistics Canada, National Income and Expenditure Accounts

CHART II-2

EXPENDITURES BY LEVEL OF GOVERNMENT
AS A PERCENT OF GNP



Source: Statistics Canada, National Income and Expenditure Accounts.

TABLE II-6

FEDERAL AND PROVINCIAL GOVERNMENT SURPLUSES OR DEFICITS, 1971-72 TO 1979-80

Fiscal Year	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	Federal
					$ Millions						
1971-72	-108	- 1	- 11	- 9	87	- 506	- 4	20	-131	145	332
1972-73	- 58	2	- 9	- 22	123	- 344	34	31	- 24	128	514
1973-74	- 56	*	- 6	6	210	- 321	7	95	254	240	825
1974-75	- 92	- 5	- 8	- 50	272	- 730	- 35	191	860	17	1,301
1975-76	-175	- 11	- 57	- 78	- 283	-1,440	- 80	121	709	-460	-2,142
1976-77	-139	*	- 28	- 86	- 332	-1,026	- 59	52	942	161	-2,900
1977-78(1)	- 49	- 22	-108	- 96	- 59	-1,465	-259	4	1,928	233	-6,902
1978-79(1)	- 63	*	- 72	- 75	- 758	-1,005	-119	-6	1,498	96	-8,063
1979-80(2)	- 92	- 2	- 82	- 41	-1,196	-1,589	-113	68	853	35	-7,474
					% of Gross Domestic Product						
1971-72	-8.3	- .4	- .5	- .5	.4	- 1.3	- .1	.6	-1.6	1.4	.3
1972-73	-4.3	.7	- .3	-1.1	.5	- .8	.8	.8	- .3	1.1	.5
1973-74	-3.5	.1	- .2	.2	.7	- .6	.1	2.0	2.2	1.6	.7
1974-75	-4.9	-1.3	- .2	-1.7	.8	- 1.2	- .6	3.0	5.5	.1	.9
1975-76	-8.2	-2.2	-1.4	-2.4	- .7	- 2.2	-1.1	1.7	3.8	-2.4	- 1.3
1976-77	-5.5	*	- .6	-2.4	- .7	- 1.3	- .7	.7	4.4	.7	- 1.5
1977-78(1)	-1.7	-4.1	-2.1	-2.4	- .1	- 1.8	-3.1	*	7.9	.9	- 3.3
1978-79(1)	-2.1	*	-1.3	-1.7	- 1.4	- 1.1	-1.3	-.1	5.3	.3	- 3.4
1979-80(2)	-2.6	- .3	-1.3	- .8	- 1.9	- 1.6	-1.1	.6	2.5	.1	- 2.8
					$ Per Capita						
1971-72	-207	- 9	- 14	- 14	14	- 66	- 4	22	- 80	66	15
1972-73	-109	18	- 11	- 34	20	- 44	34	34	- 14	57	24
1973-74	-104	*	- 7	9	35	- 41	7	105	145	104	38
1974-75	-170	- 43	- 10	- 75	44	- 91	- 35	211	499	7	58
1975-76	-317	- 85	- 70	-117	- 46	- 176	- 79	133	398	-189	- 95
1976-77	-249	*	- 34	-127	- 53	- 124	- 57	56	513	65	- 126
1977-78(1)	- 87	-191	-129	-140	- 9	- 175	-252	4	1,017	94	- 298
1978-79(1)	-111	*	- 86	-108	- 121	- 119	-115	- 7	767	38	- 344
1979-80(2)	-160	- 16	- 97	- 58	- 190	- 187	-109	71	424	14	- 317

(1) Preliminary (2) Forecast * Negligible

Sources: Statistics Canada, Provincial Government Finance, (Cat. No. 68-207); Federal Government Finance, (Cat. No. 68-211); Provincial Economic Accounts, (Cat. No. 13-213).

The Issue of Federal-Provincial Fiscal Balance

Developments referred to in the previous section have led some observers to conclude that there is now "a federal-provincial fiscal imbalance" in Canada. While there is no precise definition of this concept, the most obvious indicator which gives rise to concern over fiscal balance is the deficit position of the federal government compared to the over-all surplus position of provincial governments and the relatively stable deficit position of the seven provinces without oil and gas revenues. Table II-6 presents data on these indicators in millions of dollars, in per capita terms and as shares of Gross Domestic Product or Gross Provincial Product. There is also an interprovincial dimension to the question of fiscal balance which is reviewed in Annex III.

Other Federal-Provincial Financial Links

In addition to intergovernmental transfers, there are major components of the federal-provincial fiscal arrangements which relate to tax harmonization and fiscal and economic coordination. These other components are discussed at some length in the Submission. Moreover, the Tax Collection Agreements, which are the major instrument for tax harmonization, are examined in Annex IV.

There exists also a wide range of other federal-provincial financial links. In some cases the federal government purchases various goods or services from provincial governments. For example, under the Canada Manpower Institutional Training Program, the federal government purchases various forms of institutional educational facilities and services from provinces. Conversely, eight provinces and a large number of municipalities in those provinces purchase police services from the federal government. In other cases one government will transfer land or physical assets to another government. For example, under the Hospital Transfer Program various veterans' hospitals have been transferred from the federal government to local community authorities in return for a nominal sum and assurance of treatment facilities for veterans.

Other financial links between the federal and provincial governments involve loan programs. For example, under the Canada Pension Plan, contributions to the plan are loaned to provincial governments on the basis of their origin. There are also a number of programs or joint activities where each level of government independently finances its share of responsibilities. For example, a number of CMHC programs, including Public Housing Programs, the Residential Rehabilitation Program and the Rural and Native Housing

Program, are financed by federal-provincial partnership arrangements. Moreover the federal and provincial governments jointly support a number of intergovernmental liaison bodies or joint administrative bodies. For example, both orders of government jointly finance the activities of the Federal-Provincial Committee of Officials for Human Rights.

Table II-7 presents a summary of these various federal-provincial financial links. A complete list of federal-provincial agreements and arrangements categorized by type of program or activity is presented in the bi-annual inventory of federal-provincial programs prepared by the Federal-Provincial Relations Office.[1]

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(1) Federal-Provincial Relations Office, Government of Canada, Federal-Provincial Programs and Activities; a Descriptive Inventory - 1978; June 1979. An updated version will be published soon.

TABLE II-7
FEDERAL-PROVINCIAL FISCAL LINKS

(a) Tax Harmonization

Income Tax Collection Agreements
Grants in Lieu of Property Taxes
Reciprocal Taxation Agreements

(b) Intergovernmental Transfers

Unconditional Grants
(e.g. Fiscal Equalization, Statutory Subsidies)

Conventional Conditional and/or Shared-Cost Grants
(e.g. Canada Assistance Plan)

Established Programs Financing Arrangements
(cash and tax transfers)

Contracting Out Tax Transfer

(c) Other Financial Links

Payments for Goods or Services
(e.g. Canada Manpower Institutional Training Program)

Payments Relating to the Transfer of Land,
Improvements or other Physical Assets
(e.g. Hospital Transfer Program)

Loans
(e.g. Canada Pension Plan Investment Fund)

Joint Activities Where Each Level of Government
Independently Finances Its Share of the Responsibilities
(e.g. Dairy Support Program)

Support of Intergovernmental Liaison and Joint
Administrative Bodies
(e.g. Federal-Provincial Committee of Officials
Responsible for Human Rights)

Miscellaneous
(e.g. Canada Student Loans Plan)

(d) Fiscal and Economic Co-ordination

Fiscal Co-ordination
(e.g. Annual pre-budget Meeting of Ministers of Finance)

Economic Co-ordination
(e.g. Anti-inflation program)

ANNEX III

INTERPROVINCIAL FISCAL BALANCE

The issue of fiscal balance among provinces may be examined by comparing provinces with each other or with the average for all provinces. This Annex presents a number of measures of relative provincial fiscal positions. First, the relative "fiscal capacity" of provinces is compared. Fiscal capacity is a measure of the ability of a province to derive revenue from the sources available to it. Second, the "per capita expenditures" of provinces are compared. Each of these measures is determined on a standardized basis to render them comparable and all measures are cast in an index form, with the national average, i.e., the average of all provinces, equal to 100. Third, the relative "tax effort" of provinces is compared. Tax effort is a measure of the extent to which a province cultivates the revenue sources to which it has access, again relative to other provinces.

These measures are presented to assist the Task Force in its work but no conclusions are drawn, since it would be inappropriate for the federal government to take a position about the budgetary posture of any provincial government. Since the taxing, spending and borrowing positions of any government reflect a joint set of decisions, the three measures should be considered together.

Fiscal Capacity

Relative provincial fiscal capacity as of 1977-78 is presented in Table III-1. The measure of relative fiscal capacity is derived by estimating the per capita yield in each province from a standardized tax system, that is, by applying a uniform tax rate for each component of the system to a uniform tax base in each province for such component. The first three columns of Table III-1 display the relative fiscal capacities of each province (and its local governments) to derive revenues from its own revenue sources. The first column presents indices for non-resource revenues only, the second for resource revenues only and the third for all revenues from own sources. The fourth column displays each province's relative fiscal capacity, taking into account the equalization payments certain provinces receive from the federal government. The fifth column depicts each province's relative fiscal capacity after taking into account all transfers from the federal government.

There is considerable variation in the relative fiscal capacity of provinces when calculated with reference to provincial-local revenues from their own sources alone. The position of Alberta, with an index for all own-source revenue virtually double that of any other province, is

particularly striking. The second column, relating to natural resource revenues only, provides much of the explanation for over-all fiscal capacity disparities among provinces. This column indicates that six provinces, including Ontario, have a fiscal capacity index in respect of natural resource revenues which is 10 per cent of the national average or less, while Alberta is almost 800 per cent above that average.

The effect of equalization payments is to substantially reduce the range of fiscal capacity disparities among provinces. Alberta continues to be a striking exception, with an index still virtually double that of any other province. However, the range for the nine other provinces diminishes considerably when equalization is taken into account. Moreover, the indices of all those provinces from Manitoba east fall within a very narrow spread, ranging from 84 per cent to 88 per cent of the national average.

TABLE III-1

INDICES OF PROVINCIAL-LOCAL FISCAL CAPACITY*
1977-78

Province	Own Source Revenues*			Own Source Revenues Plus Equalization	Own Source Revenues Plus All Federal Transfers
	Non-Resource Revenues	Resource Revenues	All		
Alta.	134	892	227	212	192
B.C.	113	130	115	107	104
Sask.	92	146	99	96	98
Ont.	107	8	95	88	88
Que.	89	9	79	87	92
Man.	89	9	79	88	90
N.B.	72	10	65	85	89
N.S.	72	5	64	85	88
Nfld.	62	38	59	85	92
P.E.I.	63	0	55	84	97
All provinces	100	100	100	100	100

* Based on total provincial and local revenues from own sources, subject to exclusions for interest revenues of provincial governments and all non-tax revenues of local government.

Source: Department of Finance, based mainly on data used in the seventh determination of fiscal equalization for 1977-78 and government data on transfers to provinces.

The effect of taking into account all transfer payments from the federal government is to further reduce the range of variation in the fiscal capacity indices. The indices of all provinces that receive equalization increase relative to the national average, while the indices of all provinces that do not receive equalization fall.

Expenditure Effort

Per capita provincial expenditures as of 1977-78 are set out in Table III-2. The indices in this table are based on consolidated provincial-local government expenditure for each province as published by Statistics Canada in their Financial Management System of statistics. These measures are not intended to be indices of quality, level or cost of services because there is no reliable way of measuring and separating these aspects of public expenditures as between provinces. The variation in per capita expenditures is much less than the variation in respect of fiscal capacity or tax effort. This is presumably due to the pressure on each province to provide public service levels comparable to those provided in other provinces.

TABLE III-2

CONSOLIDATED PROVINCIAL-LOCAL GOVERNMENT EXPENDITURE PER CAPITA
1977-78

Province	Consolidated Expenditure Per Capita Expressed as an Index
Alberta	118
Quebec	108
Saskatchewan	103
British Columbia	100
Manitoba	99
Prince Edward Island	96
Ontario	94
Newfoundland	88
Nova Scotia	86
New Brunswick	82
All provinces	100

Source: Department of Finance, based upon Statistics Canada data.

Tax Effort

Relative provincial tax effort as of 1977-78 is presented in Table III-3. The indices are based on all provincial and local government revenues from own sources. It would be misleading to consider only provincial revenue sources, since property taxes are levied at the provincial level in some provinces but at the local level in others. The index of tax effort relates the actual revenues derived by each province to its estimated fiscal capacity to derive such revenues by applying national average rates of taxation to its own tax bases.

Indices of tax effort are normally determined with reference to the actual revenues of each province. However, the indices in the second column of Table III-3 are determined by adjusting each province's actual revenues to take account of its deficit or surplus in 1977-78. The indices in this column therefore indicate what the relative level of tax effort in each province would be if it had total revenues sufficient to give it an average per capita or "standardized" level of surplus/deficit. The result of the adjustment is to raise a province's index of tax effort, if it has a per capita deficit that is above the average per capita deficit of all provinces, and to lower a province's tax effort if it has a per capita deficit that is below average or if it has a surplus.

The third column of Table III-3 provides a rough estimate of relative "tax burden" - a concept which is sometimes confused with tax effort. Tax effort takes into account the capacity of a province to derive revenue from all the various sources available to it, whether these revenues are imposed on individuals or business enterprises. It does not provide a measure of burden because business enterprises do not bear taxes in any final sense, but rather pass them on to their customers, owners, employees, etc. However, there is no reliable way in which the final burden of such taxes can be estimated or in which it can be allocated among provinces. The measure of relative tax burden deals with this problem by excluding taxes that are paid primarily by business enterprises. It therefore provides an estimate of the relative tax burden on individuals resident in each province by taking into account only those taxes that are paid entirely or primarily by individuals.

There are considerable differences among provinces in the level of tax effort. The variation tends to be larger when adjustments are made for the effect of deficits and surpluses. This is explained by the fact that provinces with

TABLE III-3

INDICES OF PROVINCIAL-LOCAL TAX EFFORT*
1977-78

Province	Actual Revenues	Actual Revenues Adjusted for Surpluses and Deficits	Tax Burden on Individuals
Quebec	120	122	117
Manitoba	99	116	98
P.E.I.	95	111	97
Ontario	100	110	101
Nova Scotia	95	109	98
Saskatchewan	105	105	99
Newfoundland	101	104	107
New Brunswick	84	97	87
British Columbia	98	94	98
Alberta	80	54	60
All provinces	100	100	100

* Based on provincial and local government revenues from own sources, subject to exclusions for interest revenues of provincial governments and all non-tax revenues of local governments.

Source: Department of Finance, based mainly on data used in the seventh determination of fiscal equalization for 1977-78.

high tax effort with respect to revenues from their own sources tend to incur higher than average deficits. Accordingly, their tax effort would have to be higher in order to finance the deficit. On the other hand, provinces with relatively low tax effort in respect of revenues from their own sources tend to run lower than average deficits or budgetary surpluses. This means that they are in a position to reduce taxes, and consequently tax effort, in order to have an average per capita deficit/surplus.

If one considers tax effort taking into account surpluses and deficits, the second column indicates that seven provinces have a relatively high tax effort, ranging from 104 per cent to 122 per cent of the national average. All these provinces except Ontario are currently eligible

for equalization. The measure of tax effort also indicates that the two provinces that are indicated to be above average by the present equalization formula - Alberta and British Columbia - both have below-average levels of tax effort.

These data suggest in general that provinces with a relatively low fiscal capacity tend to have a relatively high tax effort, and vice versa.

Review of Indices

Table III-4 provides a comparison of principal indices in respect of provincial-local fiscal capacity, expenditures and tax effort. This table should be interpreted with caution. In this regard it should be noted that the indices are based upon 1977-78 data and cannot reflect changes that have taken place since that time. Also, it bears repeating that the index of tax effort is not an index of tax burden. Further, the measure of expenditures does not take account of any differences that may exist among provinces in the costs of, and needs for, public services.

TABLE III-4

SUMMARY OF INDICES OF PROVINCIAL-LOCAL FISCAL CAPACITY, PER CAPITA EXPENDITURES AND TAX EFFORT, 1977-78

Province	Fiscal Capacity (Own Source Revenues Plus all Federal Transfers)	Per Capita Expenditures	Tax Effort (Actual Revenues Adjusted for Surpluses and Deficits)
Alberta	192	118	54
British Columbia	104	100	94
Saskatchewan	98	103	105
Prince Edward Island	97	96	111
Quebec	92	108	122
Newfoundland	92	88	104
Manitoba	90	99	116
New Brunswick	89	82	97
Ontario	88	94	110
Nova Scotia	88	86	109
All provinces	100	100	100

Source: Tables III-1, III-2 and III-3 above.

It will be noted that provinces tend to fall into certain groups. For example:

- One province has relatively high fiscal capacity, high expenditures and low tax effort (i.e., Alberta).
- Some provinces have relatively low fiscal capacity and high tax effort, with below-average expenditures (notably Nova Scotia, Ontario and Newfoundland).
- Some provinces have relatively low fiscal capacity and very high tax effort, with average or above-average expenditures (i.e., Quebec and Manitoba).
- One province has close to average fiscal capacity and high tax effort, with close to average expenditures (i.e., Prince Edward Island).
- One province has relatively low fiscal capacity and expenditures but close to average tax effort (i.e., New Brunswick).
- Some provinces are relatively close to average in respect of all three measures (notably British Columbia and Saskatchewan).

These relationships are generally consistent with what one would expect. Thus, one would expect a tendency for high fiscal capacity to be linked with high expenditures and/or low tax effort. Similarly, one would expect a tendency for low fiscal capacity to be linked with low expenditures and/or high tax effort. Also, one would expect a tendency for average fiscal capacity to be linked with average expenditures and/or average tax effort. Further, a province can achieve high expenditures despite low fiscal capacity if it has high tax effort. Indeed, the relationships between the three indices for each of the ten provinces appear to be explainable in terms of these tendencies.

ANNEX IV

INCOME TAX COLLECTION AGREEMENTS

The Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977 provides authority for the federal government to enter into agreements with provinces to administer and collect on their behalf their income taxes. Such income tax collection agreements have been in effect with nine provinces since 1962, with the Northwest Territories since 1978, and with the Yukon since 1980. There has never been an agreement with Quebec and the agreements with Ontario and Alberta now cover the individual income taxes only. During 1981-82, the Government of Canada will remit to provinces over $9 billion of income taxes assessed on their behalf.

Immediately prior to the Second World War, the federal, provincial and some municipal governments were levying income taxes with little coordination. Certain types of income could be subject to double taxation and, as a result, very heavy tax rates, while other income could avoid tax altogether. The pre-war period has therefore been called the "tax-jungle" period.

The main objective of the tax rental arrangements, which were introduced in 1941, was to ensure that the federal government would have unimpeded access to the revenues necessary to finance the war effort and would be able to spread the burden equitably. This assurance did not exist with the uncoordinated system of rates and exemptions that prevailed under the existing municipal, provincial and federal income tax systems. Under the tax rental arrangements, provincial governments and their municipalities withdrew from the income tax fields, leaving them for sole occupancy by the federal government. In return, the federal government made "tax rental payments" to the provinces. The rental arrangements were renegotiated over three successive five-year periods until they were replaced in 1962 with the present tax collection arrangements.

The tax rental arrangements guaranteed the federal government sole occupancy of the income tax field and resolved the "tax jungle" problems of the pre-war period. However, they denied participating provinces flexibility in respect of a major revenue source. In addition, the federal government was concerned about being perceived as the sole taxing authority when, in fact, provinces were receiving a substantial part of the tax revenues.

The tax collection arrangements which were introduced in 1962 were designed to resolve these problems; they became the most significant component of the tax harmonization system. Under these arrangements, each province legislates its own income tax. The federal government then enters into an agreement with the province under which it undertakes to administer the provincial act and collect the tax, free of charge, if the province agrees to meet certain conditions. Originally, the primary conditions were that the tax bases used by provinces conform to the bases defined in the federal Income Tax Act (i.e., "basic federal tax" in the case of the individual income tax and "corporation taxable income" in the case of the corporation income tax) and that the progressivity of the federal individual income tax be maintained in the combined federal and provincial system. This was accomplished through the design by the federal government of a "model" provincial Income Tax Act which mirrored the federal legislation. While participating provinces are still required to maintain a tax base which conforms to the federal tax base, the conditions have been relaxed. For example, the uniform progressivity condition that was ensured by requiring provinces to express their tax as a single percentage rate of federal tax has been eased. The introduction of a variety of provincial tax credits and other special measures, which the federal government has agreed to administer, has altered the effective degree of progressivity of the combined federal-provincial income tax system on a province by province basis.

Tax collection agreements were signed in 1962 with all provinces except Quebec, but the agreement with Ontario covered only the individual income tax. In 1978, an agreement was entered into with the Northwest Territories and in 1980 with the Yukon Territory. Alberta began administering its corporation income tax in 1981. Therefore, the tax collection agreements system applies at present to all provinces except Quebec in respect of the individual income tax, and to the seven provinces other than Quebec, Ontario and Alberta in respect of the corporate income tax. The authority for the agreements is Part III the <u>Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977</u> and the respective provincial income tax acts. The agreements do not have any fixed termination date.

The tax collection agreements have made a critical contribution to the maintenance of a high degree of uniformity and harmony in the national income tax system. Tax rates, of course, can and do vary. The relative uniformity of the system has a number of definite advantages. First, it enables a taxpayer to use only one tax form, thus simplifying his task. Second, it enables a single administrative agency to

administer efficiently both federal and provincial acts, thus reducing collection costs. Third, the relative uniformity of the tax base enables taxpayers to make economic decisions without having to take into account major differences among provincial tax systems. Fourth, the use of a common allocation formula for apportioning income among provinces ensures that elements of income do not avoid tax and are not taxed by more than one province.

However, it has been argued that the tax collection system impinges on provincial freedom and limits the flexibility of provincial governments in determining appropriate fiscal policies for their respective jurisdictions. Also, since the federal government must consider the direct and indirect effects of its tax changes on provincial governments, federal flexibility is impaired.

The provinces' search for flexibility arises out of the growing importance to them of income tax revenue and their desire to use their income taxes to achieve social and economic policy objectives. The provincial share of total income tax revenues has increased from 15 per cent in 1962 to over 40 per cent at present. Also, since 1972, the federal government has undertaken to administer a number of special measures put forward by provincial governments. These include tax credits, tax rebates, tax reductions, tax surcharges and dual corporate tax rates. Tables IV-I and IV-2 list the special provincial measures which are in effect for 1981 and which are being administered by the federal government. In order to give a more complete picture of provincial income tax structures for those provinces whose taxes are collected by the federal government, Table IV-3 sets out 1981 tax rates as currently known. Finally, Table IV-4 summarizes the value of provincial taxes assessed by the federal government on behalf of provinces.

Recently, the tax collection agreements have come under some pressure. This pressure arises mainly from the greater use of the income tax system by both orders of government to reach various objectives .

First, the proliferation of special provincial income tax credits and other measures has complicated calculations for taxpayers and tax administration for Revenue Canada, thereby eroding the simplicity of the system.

Second, the introduction of special measures has altered the progressivity of the combined federal and provincial individual income tax system. It must therefore be assumed that the equity objective which was to be achieved by requiring uniform progressivity now has a lower priority.

Third, special incentive measures in the corporate income tax system to encourage economic activity within a province have put pressure on other provinces to compete. This, in turn, may be leading to undesirable inter-provincial tax competition.

In order to relieve this pressure and to preserve the objectives of the tax collection arrangements, three general guidelines are followed to determine whether or not a measure will be administered under tax collection agreements. First, the measure must be able to be administered reasonably effectively. Second, the measure must not significantly erode or have the potential to erode the essential harmony and uniformity of the federal and provincial income tax systems. Third, the measure must not jeopardize the efficient functioning of the Canadian economic union by the erection of income tax barriers to normal interprovincial investment flows.

Recent evidence of discriminatory tax treatment demonstrates the dilemma arising out of the conflict between the provinces' desire for flexibility and the desirability of maintaining relative uniformity in the national income tax system. Extending full flexibility to participating provinces would result in a loss of the advantages of tax harmony and relative uniformity. On the other hand, restricting the flexibility of provinces too severely could drive them out of the tax collection agreements altogether.

In attempting to resolve this dilemma it is necessary to examine the main components of the provincial tax system and to determine the degree of flexibility that can be extended to provinces without impairing the basic objectives of the tax collection arrangements.

The major components of the provincial tax system are the tax base and the tax rates, including both the nominal rate and any special measures which result in a different effective rate. The tax base for the provincial individual income tax is basic federal tax of individuals resident in a province on the last day of the taxation year. The base of the provincial corporate income tax is federal corporation taxable income earned in the province in the taxation year. There is agreement, even by provinces outside the tax collection agreements, on the importance of a common tax base definition and common rules for the allocation of the base. This concept will not likely come under serious challenges although there has been one occasion recently when a province made a request that would have resulted in a change to the tax base. This request was turned down because it would have violated the common tax base definition and set a precedent for other such requests.

The other major component of a provincial tax system is the rate structure. Originally, the agreements required provinces to express both their individual and corporate tax rates as a single percentage of the tax base. This requirement was subsequently eased when a second provincial corporate rate on "small business", paralleling the federal small business deduction, began to be administered. The requirement of a single rate for the individual income tax remains. There may be some interest in establishing more than one rate of personal income tax and additional rates for corporations. In the case of the personal income tax, some provinces might prefer to levy their tax on federal "taxable income" rather than on "basic federal tax". In the case of corporations, provinces might wish to offer special manufacturing and/or processing rates. These would, however, complicate the tax system, be very difficult to administer and would result in loss of uniformity.

Other aspects of the tax rate component of the provincial tax system relate to the special measures, such as credits, rebates and reductions, which have been introduced since 1972. These measures all change effective tax rates. More importantly, they can result in the establishment of tax barriers to interprovincial investment flows and eventually lead to undesirable tax competition which is not in the interest of the economic union. In the last two years the federal government has refused to administer provincial income tax measures of this latter type.

The future of the current tax collection arrangements is therefore somewhat problematical. If participating provinces - particularly the larger ones - cannot find the minimum flexibility that will ensure their continued participation in the agreements, they may withdraw. Because it wished to introduce a variety of incentives and innovations into its corporate income tax structure which it knew the federal government could not agree to administer, the Alberta government has withdrawn from the tax collection agreement covering the corporate income tax effective with 1981. The British Columbia government has served notice of its intention to withdraw from the tax collection agreement completely unless the federal government agrees to administer proposed dividend and venture capital tax credits which it is felt would lead to the kinds of undesirable effects on the economic union outlined above. As noted, Quebec has never participated in the tax collection agreements and Ontario has always collected its own corporate income tax.

The full withdrawal by British Columbia would, when added to Quebec and Ontario's non-participation and Alberta's partial withdrawals, have serious implications for the future of the tax collection arrangements. Even now, with Ontario, Quebec and Alberta (which account for over

75 per cent of corporate taxable income earned in Canada), administering their own corporate income taxes, there is a significant potential for disharmony. The usefulness of such arrangements to maintain relative uniformity and harmony in the national income tax system is seriously impaired by the non-participation of one or more of our four most populated provinces. There are, however, indications that concern over the drift to tax competition and disharmony is shared by some provinces. For example, the Minister of Finance for British Columbia, Mr. Curtis, stressed in his latest budget address the desirability of all governments refraining from competitive discriminatory measures.

TABLE IV-1

SPECIAL FEATURES OF PROVINCIAL
PERSONAL INCOME TAX SYSTEMS
1981

Prov.	Tax Credits	Tax Rebates	Tax Reductions	Surcharges
Nfld.	-	-	-	-
P.E.I	-	-	-	-
N.S.	-	-	-	-
N.B.	Political Contributions	-	-	Negative surtax of 5.5% of provincial tax otherwise payable
Ont.	Property, Sales Tax, Political Contributions	-	Selective	-
Man.	Property, Cost of Living, Political Contributions	Royalties	Selective	-
Sask.	Mortgage Interest	Royalties	Selective	Surcharge of 11% on provincial tax in excess of $4,000
Alta.	Royalties, Renters, Political Contributions	Royalties	Selective	-
B.C.	Renters, Political Contributions, Cost of Living	Royalties	Selective	Surcharge of 10% on provincial tax in excess of $3,500

Note: Special features in effect as of April 23, 1981.

TABLE IV-2

SPECIAL FEATURES OF PROVINCIAL
CORPORATE INCOME TAX SYSTEMS
1981

Prov.	Tax Credits	Tax Rebates	Small Business Rate Reduction
Nfld.	-	-	3 points
P.E.I.	-	-	-
N.S.	-	-	3 points
N.B.	-	-	5 points
Man.	Political Contributions	-	4 points
Sask.	-	Royalties	4 points
Alta.	Royalties, Political Contributions	Royalties	6 points
B.C.	Logging Tax, Political Contributions	Royalties	8 points

Note: Special features in effect as of April 23, 1981.

TABLE IV-3

PROVINCIAL INDIVIDUAL AND CORPORATE
INCOME TAX RATES - 1981
(per cent)

Province	Individual	Corporate
Newfoundland	58.0	15-12
Prince Edward Island	52.5	10
Nova Scotia	52.5	13-10
New Brunswick	55.5	14-9
Quebec	-	-
Ontario	44.0	-
Manitoba	54.3	15-11
Saskatchewan	52.0	14-10
Alberta	38.5	11-6
British Columbia	44.0	16-8
Northwest Territories	43.0	10
Yukon	43.0	10

Notes: Rates in effect as of April 23, 1981.

Individual income taxes are expressed as a percentage of basic federal tax and corporate income taxes are expressed as a percentage of federal corporate taxable income.

The above rates are the nominal rates and can vary depending on the application of the special measures outlined in Tables IV-1 and IV-2.

Since Quebec collects its own income taxes and Ontario collects its own corporate income tax and the bases for these taxes differ from those used by other provinces, the rates for these taxes are not comparable to other provinces and are not shown. While Alberta has begun collecting its own corporate income tax in 1981, the tax base is the same as that used by other provinces and the Alberta corporate rates are therefore comparable.

TABLE IV-4

ESTIMATED 1981 PROVINCIAL INCOME TAXES
ASSESSED BY FEDERAL GOVERNMENT
($ million)

	Individual Income Tax	Corporation Income Tax	Total
Gross Provincial Tax	8,720	1,340	10,060
Credits, Reductions, Surcharges	605	309	914
Net Provincial Taxes	8,115	1,031	9,146

Note: The federal government makes payments to provinces in respect of income taxes levied under provincial income tax acts which are administered by the federal government. The payments to provinces are made on the basis of provincial income tax assessed. Amounts actually received by the federal government may be less because of uncollectables.

ANNEX V

FISCAL EQUALIZATION

Fiscal equalization is a federal program, authorized by Part I of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, under which unconditional transfers are made to certain provinces. The purpose of the program is to ensure:

> "... that all provinces are able to provide to their citizens a reasonably comparable level of basic services, without resorting to unduly burdensome levels of taxation."

This statement was made by former Minister of Finance, Mitchell Sharp, when he introduced and described the current equalization formula to Provincial Ministers of Finance in September, 1966. The federal government therefore makes equalization payments because provinces have varying capacities to raise revenues from taxation to finance the services for which they are responsible under the Constitution. There are also differences among provinces in the cost of providing any given level of public services, but such differences are very difficult if not impossible to measure. As a consequence, equalization has always been calculated with reference to relative revenue-raising capacity, and paid to provinces which are below some specified standard.

There has been some misunderstanding recently that the purpose of the existing program is not only to assist lower-income provinces with the financing of public services, but also to redistribute among provinces the revenues accruing to the more well-to-do. While the program does result in some redistribution of income from federal taxpayers in certain provinces to the residents of other provinces, this is an indirect and secondary consequence of the program. In this respect the Fiscal Equalization Program does not differ from any other federal program whose benefits are directed to specific regions or target groups. The present program is not intended to be a vehicle for securing and redistributing the above-average revenues which certain provincial governments have the good fortune to receive.

It may be said that, since the beginning of Confederation, certain federal payments to provinces, such as the Statutory Subsidies, have taken account of the need to provide financial assistance to lower-income provinces. The modern concept of equalization, however, while related to this long-perceived need, is based upon a comparison of the yield or productivity of taxes in the different provinces, or in the language of economists, of differences in "fiscal capacity". Only recently have interprovincial comparisons of

fiscal capacity become possible. In Canada this may be said to have become technically feasible with the advent of the tax rental agreements in 1941. Indeed, there were elements of implicit equalization built into the tax rental agreements of 1941, 1947 and 1952. However, it was not until the fourth and last set of agreements, in 1957, that equalization became established as a separate and identifiable program.

The 1957 tax rental agreements provided for a system of equalization based upon provincial revenues from the three tax fields that provinces rented to the federal government, i.e., the personal income tax, corporation income tax and succession duties. Since these taxes (or a similar tax in the case of succession duties, i.e., estate tax) were collected by the federal government for itself in all ten provinces, and since elaborate rules for allocating tax by province had been developed, it was a simple matter to compare the productivity of yields in all provinces. The comparison was made in respect of the revenues that provinces would receive from the three taxes on the assumption that they all entered rental agreements, based upon the rates specified for participating provinces.

The "standard of equalization" was the weighted average per capita yield of these taxes in the two provinces with the highest per capita yields. Provinces with lower yields therefore received equalization payments to compensate for the amount of their shortfall. The equalization formula was essentially "open-ended", i.e., without any limit on total payments. This was important because payments tended to grow each year in response to the rapid growth in yields of the taxes concerned. A province could qualify for payments irrespective of whether it participated in the tax rental agreements. Payments were made each year to nine provinces, including Alberta and British Columbia. Only Ontario, the richest province, never received a payment. (Tables V-1, V-2, and V-3 present a history of equalization payments to each province since 1957-58).

In 1962-63 the tax rental agreements were replaced by tax collection agreements, with the provinces free to set their own rates of tax. Equalization was continued but remained tied to fixed or standard rates of the two income taxes and succession duties. As a consequence, revenues from higher rates of taxation which were introduced in some provinces were not equalized. The equalization standard was lowered from the top two provinces to the national average, but 50 per cent of natural resource revenues were brought in. These changes had the effect of excluding Alberta and British Columbia from equalization and of altering the distribution of payments to conform more closely to observed needs.

TABLE V-1

EQUALIZATION ENTITLEMENTS BY PROVINCE, 1957-58 to 1981-82
(in millions of dollars)

Fiscal Year	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	Total
1957-58	11.8	3.1	17.2	8.6	46.4	-	14.2	20.3	12.0	5.5	139.1
1958-59	20.1	5.6	26.3	22.6	63.3	-	13.5	20.4	13.4	6.7	191.9
1959-60	22.1	6.0	27.9	24.6	78.1	-	14.8	23.5	16.4	5.9	219.3
1960-61	20.3	5.6	25.9	24.0	69.9	-	13.3	21.9	15.4	6.0	202.3
1961-62	20.9	5.4	26.3	24.1	72.7	-	13.4	23.3	14.3	5.6	206.0
1962-63	24.0	6.9	29.1	25.5	68.8	-	13.7	22.9	12.3	-	203.2
1963-64	23.8	7.2	31.3	27.0	65.3	-	12.9	21.9	7.1	-	196.5
1964-65	27.1	8.1	37.7	33.0	96.1	-	18.7	22.0	1.2	-	243.9
1965-66	34.9	9.5	43.8	39.9	133.1	-	27.2	29.2	-	-	317.6
1966-67	39.2	10.5	47.9	44.2	151.3	-	30.5	31.4	-	-	355.0
1967-68	65.7	14.2	75.1	63.6	268.7	-	39.9	25.1	-	-	552.3
1968-69	73.2	16.2	84.0	71.8	386.6	-	49.3	26.4	-	-	707.5
1969-70	95.7	19.5	96.8	87.9	430.7	-	52.6	66.1	-	-	849.3
1970-71	97.3	19.9	99.5	93.1	420.1	-	54.7	99.0	-	-	883.6
1971-72	105.2	20.0	107.6	93.0	453.3	-	71.9	88.8	-	-	939.8
1972-73	113.7	25.2	123.9	103.2	534.3	-	68.1	102.0	-	-	1,070.4
1973-74	156.0	33.3	186.0	146.3	737.1	-	112.6	116.1	-	-	1,487.4
1974-75	174.7	42.5	232.0	168.5	918.4	-	124.5	50.6	-	-	1,711.2
1975-76	189.1	47.7	252.0	187.4	1,049.4	-	150.8	-	-	-	1,876.4
1976-77	229.2	54.4	298.1	232.4	1,062.9	-	153.3	10.4	-	-	2,040.7
1977-78	278.1	63.0	342.1	273.3	1,322.0	-	236.5	58.2	-	-	2,573.2
1978-79	321.2	71.6	375.4	331.3	1,482.8	-	291.7	32.7	-	-	2,906.7
1979-80*	347.9	80.9	422.7	312.5	1,682.8	-	348.6	76.0	-	-	3,271.4
1980-81*	376.4	88.0	449.1	378.7	1,720.8	-	342.6	40.2	-	-	3,395.8
1981-82*	410.9	94.4	480.0	411.7	1,779.7	-	355.1	55.2	-	-	3,587.0

* Most recent estimates.
Source: Department of Finance.

TABLE V-2

EQUALIZATION ENTITLEMENTS BY PROVINCE, 1957-58 TO 1981-82
(In dollars per capita)

Fiscal Year	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	Total
1957-58	28	31	25	15	10	-	16	23	10	4	13
1958-59	47	56	37	40	13	-	15	23	11	4	17
1959-60	50	59	39	42	16	-	17	26	13	4	19
1960-61	45	54	36	41	14	-	15	24	12	4	17
1961-62	46	51	36	40	14	-	15	25	11	3	17
1962-63	51	65	39	42	13	-	15	25	9	-	22
1963-64	50	67	42	44	12	-	14	23	5	-	21
1964-65	56	74	50	54	17	-	19	23	1	-	26
1965-66	72	87	58	65	23	-	28	31	-	-	33
1966-67	79	96	63	72	26	-	32	33	-	-	37
1967-68	132	130	99	103	46	-	41	26	-	-	57
1968-69	145	148	110	115	65	-	51	28	-	-	72
1969-70	186	176	125	140	72	-	54	69	-	-	85
1970-71	188	181	127	148	70	-	56	105	-	-	89
1971-72	202	179	136	147	75	-	73	96	-	-	94
1972-73	215	223	156	161	88	-	69	112	-	-	107
1973-74	290	292	231	226	121	-	113	128	-	-	148
1974-75	323	369	286	258	150	-	124	56	-	-	169
1975-76	344	407	308	282	170	-	149	-	-	-	201
1976-77	411	460	360	343	170	-	150	11	-	-	197
1977-78	493	524	410	398	211	-	230	62	-	-	246
1978-79	565	587	446	477	236	-	282	35	-	-	277
1979-80*	606	658	499	446	268	-	338	79	-	-	311
1980-81*	649	708	527	536	273	-	333	41	-	-	321
1981-82*	702	756	559	578	281	-	345	56	-	-	338

* Most recent estimates.
Source: Department of Finance.

TABLE V-3

PER CENT DISTRIBUTION OF EQUALIZATON ENTILEMENTS, 1957-58 TO 1981-82

Fiscal Year	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	Total
1957-58	8.5	2.2	12.4	6.2	33.3	-	10.2	14.6	8.6	4.0	100.0
1958-59	10.5	2.9	13.7	11.8	33.0	-	7.0	10.6	7.0	3.5	100.0
1959-60	10.1	2.7	12.7	11.2	35.6	-	6.8	10.7	7.5	2.7	100.0
1960-61	10.0	2.8	12.8	11.9	34.5	-	6.6	10.8	7.6	3.0	100.0
1961-62	10.2	2.6	12.8	11.7	35.3	-	6.5	11.3	6.9	2.7	100.0
1962-63	11.8	3.4	14.3	12.6	33.8	-	6.7	11.3	6.1	-	100.0
1963-64	12.1	3.7	15.9	13.8	33.2	-	6.6	11.1	3.6	-	100.0
1964-65	11.1	3.3	15.4	13.6	39.4	-	7.7	9.0	0.5	-	100.0
1965-66	11.0	3.0	13.8	12.5	41.9	-	8.6	9.2	-	-	100.0
1966-67	11.0	2.9	13.5	12.5	42.6	-	8.6	8.9	-	-	100.0
1967-68	11.9	2.6	13.6	11.5	48.7	-	7.2	4.5	-	-	100.0
1968-69	10.3	2.3	11.9	10.2	54.6	-	7.0	3.7	-	-	100.0
1969-70	11.3	2.3	11.4	10.3	50.7	-	6.2	7.8	-	-	100.0
1970-71	11.0	2.3	11.3	10.5	47.5	-	6.2	11.2	-	-	100.0
1971-72	11.2	2.1	11.5	9.9	48.2	-	7.7	9.4	-	-	100.0
1972-73	10.6	2.4	11.6	9.6	49.9	-	6.4	9.5	-	-	100.0
1973-74	10.5	2.2	12.5	9.8	49.6	-	7.6	7.8	-	-	100.0
1974-75	10.2	2.5	13.6	9.8	53.6	-	7.3	3.0	-	-	100.0
1975-76	10.1	2.5	13.4	10.0	56.0	-	8.0	-	-	-	100.0
1976-77	11.2	2.7	14.6	11.4	52.1	-	7.5	0.5	-	-	100.0
1977-78	10.8	2.4	13.3	10.6	51.4	-	9.2	2.3	-	-	100.0
1978-79	11.1	2.5	12.9	11.4	51.0	-	10.0	1.1	-	-	100.0
1979-80*	10.6	2.5	12.9	9.6	51.4	-	10.7	2.3	-	-	100.0
1980-81*	11.1	2.6	13.2	11.1	50.7	-	10.1	1.2	-	-	100.0
1981-82*	11.5	2.6	13.4	11.5	49.6	-	9.9	1.5	-	-	100.0

* Most recent estimates.
Source: Department of Finance.

In 1964-65, the equalization standard was restored to the top two provinces. However, British Columbia and Alberta continued to be excluded because of a new provision that natural resource revenues (again 50 per cent only) would be introduced as a negative factor for those provinces which were above the national average in revenues of this kind.

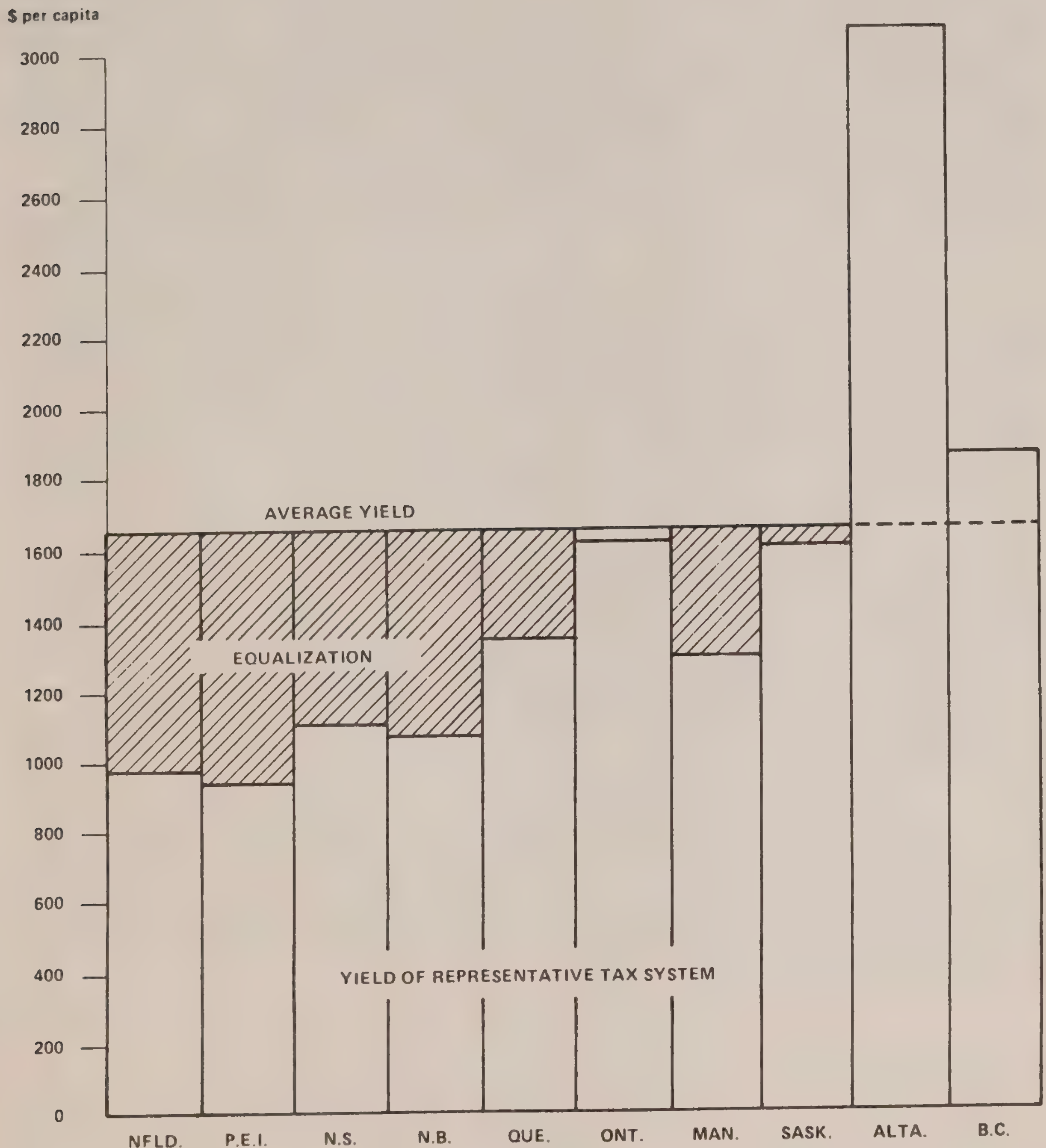
In 1967-68, the present system of equalization was introduced following a lengthy study by the federal government and the provinces. The new system brought in virtually the whole range of provincial revenues from own sources, including all of the revenues derived from consumption taxes and natural resource levies. It reverted to the national average standard of equalization which had been introduced in 1962-63. The open-ended nature of the formula was reinforced because the tie to the yield of taxes levied at specified rates was dropped. Equalization was calculated with reference to tax yields freely and collectively determined by the provinces.

The problem of comparing provincial tax yields became much more difficult once equalization was extended to taxes of a kind that the federal government does not levy for itself, because provinces levy different kinds of taxes and have widely-varying tax structures even where they impose the same taxes. However, comparisons had to be made on a uniform basis if the formula was to be equitable. In order to deal with this problem, a concept known as the "representative tax system" was introduced. This is a system which is intended to be "typical" or "representative" of the separate systems which are actually in effect in the ten provinces. The key elements of the system are (i) the division of the provincial tax system into component parts, usually one for each major kind of tax; (ii) the definition of a typical tax base for each component part of the system; and (iii) the allocation of each tax base among provinces in order to reflect their relative capacities to derive revenues.

In calculating equalization, the potential yield of each revenue source included in the representative tax system is estimated for each province by applying to its own share of the typical tax base for that revenue source the average rate of tax computed for all ten provinces. The per capita yield for each province from this representative tax system is then compared with the per capita yield for all ten provinces. A province's per capita equalization entitlement is then equal to the amount (if any) by which its per capita yield from the representative tax system falls short of the per capita yield of the system in all provinces. (See Chart V-1).

CHART V-1

EQUALIZATION ENTITLEMENTS PER CAPITA
1980-81



The representative tax system introduced in 1967-68 related to virtually all provincial revenues from own sources. These were divided into 16 categories, or "revenue sources", as they are called. A separate base was established for each revenue source. Payments to provinces increased by more than 50 per cent in the year the new formula was introduced. Seven provinces qualified for payments each year -- Newfoundland, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Manitoba and Saskatchewan. Alberta received payments of equalization for three years, but these were really transitional payments, arising by reason of its eligibility under the previous arrangements. Saskatchewan experienced a reduction in equalization in the first year of the new formula, as had been expected, but subsequently enjoyed large increases in payments.

When the program was renewed in 1972-73 a number of technical changes in the representative tax system were made. These included a reclassification of revenues from 16 sources into 19 and changes in the measures of fiscal capacity for a number of revenue sources. In 1973-74, a twentieth revenue source, school purpose taxes, was added. This was a significant change because, up to that time, no local government revenues had been included in the equalization formula.

In 1974-75, equalization in respect of "windfall" revenues of the provinces from oil and gas was limited to one-third. Windfall revenues were defined as any increase in revenues beyond the level existing in 1973-74 (the fiscal year when the historic climb in world oil prices began) other than increases resulting from a higher volume of production. At the same time, provincial revenues from oil and gas were reclassified into six sources from four, giving a total of 22 sources in all.

The seven provinces which qualified for equalization under the 1967-71 arrangements continued to qualify during the 1972-76 period except that the Province of Saskatchewan did not qualify in 1975-76. The latter was a year of exceptional prosperity in that province and its fiscal capacity, as measured by the representative tax system, rose above the national average.

In 1977-78, the Fiscal Equalization Program was renewed for a further period of five years to 1981-82. Payments increased substantially in 1977-78, largely because of the transfer of room under the personal income tax to provinces in conjunction with the new Established Programs Financing arrangements. A number of changes were made to the formula at that time. The revenue sources of the representative tax system were reclassified into 29 categories.

New tax bases were devised for a number of revenue sources, including the personal and corporation income taxes. The change for the personal income tax was introduced to take account of modifications to provincial income taxes resulting mainly from the introduction of provincial tax credits in recent years. The change for the corporation income tax was introduced to neutralize the effects of provincial nationalizations of privately-owned, profit-making corporations. The distinction between "windfall" and "basic" revenues from oil and gas was dropped and all revenues from oil and gas were now to be equalized to the extent of 50 per cent. In addition, revenues from other types of non-renewable resources, previously equalized to the extent of 100 per cent, were also to be equalized to the extent of 50 per cent. Finally, a provision was added whereby not more than one-third of total equalization could relate to natural resource revenues.

The perennial issue relating to the Fiscal Equalization Program is whether the amounts transferred to provinces are appropriate given the objective of the program, which, as discussed above, is to enable all provinces to provide a reasonable level of public services without having to impose unduly high tax rates. In other words, is the formula used to determine the amounts appropriate or is there another formula which would yield more appropriate results?

In this respect, the most important specific issue concerns the treatment of natural resources. There is a question at the outset whether natural resource revenues should be included in the formula at all, given the fact that they account for little more than one per cent of total revenues in seven provinces with approximately 76 per cent of total provincial population. Natural resource revenues, therefore, cannot be considered as a normal means of financing a reasonable level of public services in most provinces. Some provinces which obtain revenues from oil, gas and minerals have argued that these revenues derive from the sale of assets and hence ought not to be equalized at all. Also, academics and others have objected to the fact that the federal revenues which are required to equalize resource revenues of Western Provinces come to a considerable extent from federal taxpayers in Ontario since the federal government derives a relatively small share of its revenues from natural resources.

The complete exclusion of natural resource revenues would ignore the fact that when resource-rich provinces derive additional revenues from resources, this enables them to make reductions in non-resource revenues which would otherwise be included in equalization to the extent of 100 per

TABLE V-4

MAJOR CHANGES IN EQUALIZATION FORMULA SINCE 1967-68

Year	Nature of Change
1972-73	Shared federal revenues brought into equalization (Public Utilities Income Tax Transfer Act payments and, potentially, shared revenues from offshore minerals).
1973-74	Local government revenues levied for school purposes brought into equalization.
1974-75	Two-thirds of "windfall" revenues from oil and gas, defined as revenues in excess of 1973-74 levels, excluded from equalization.
1977-78	Concept of windfall revenues from oil and gas dropped, but one-half of <u>all</u> revenues from non-renewable resources (oil, gas and metallic and non-metallic minerals) excluded from equalization.
	Natural resource ceiling added to formula: total equalization in respect of natural resource revenues may not exceed one-half of total equalization in respect of non-resource revenues.
	Any province excluded from equalization if its personal income per capita is regularly above the national average personal income per capita.
1979-80	Beginning of phase-out of revenues from oil and gas land sales: one-half of previously eligible revenues excluded in 1979-80, all of them in 1980-81.

cent. In addition, it would have significant distributional effects on equalization because there are substantial and growing differences among the equalization-receiving provinces in respect of their capacity to derive revenues from natural resources. Moreover, the distributional effect of excluding resource revenues from equalization could not be offset by other changes which could be made to enrich equalization. Furthermore, the exclusion of all natural resource revenues would result in a reduction of more than $1 billion in equalization entitlements. This would lower the program payout to the point where equalization might not fulfill its objective of making it possible for all provinces to finance reasonable levels of public services.

A further dimension of this issue is whether successive changes in the treatment of natural resources in equalization have compromised the capacity of the program to achieve its stated objective. A list of the major changes in equalization since the present system began in 1967-68 is set out in Table V-4. This table indicates the dominant role of natural resource revenues in formula changes. Given the objective of equalization, a strong argument can be made that these changes have been necessary to preserve the integrity of the program.

The treatment of natural resources in equalization has also challenged the longstanding assumption that the essential purpose of the program is to make it possible for all provinces to provide a reasonable level of public services. There is little relationship between interprovincial disparities in natural resources and the need for financing public services. However, there is an obvious relationship between these interprovincial disparities and the need to redistribute the large economic rents from natural resources. This had led economists from both Eastern and Western Canada to raise a number of questions: should the objective of equalization be enlarged to encompass the concept of redistributing wealth? Also, should equalization continue to be funded entirely by the federal government or should some portion of the program -- particularly that relating to natural resource revenues -- be funded by those provinces that are above average in fiscal capacity? Alternately, should there be a separate and complementary program which might redistribute a portion of natural resource revenues among provinces?

ANNEX VI

ESTABLISHED PROGRAMS FINANCING

Under the Established Programs Financing (EPF) arrangements, which came into effect on April 1, 1977, federal contributions to the provinces for three of the four major shared-cost programs - Hospital Insurance, Medicare and Post-Secondary Education - are no longer tied to provincial expenditures on the basis of 50:50 cost-sharing formulae. Rather federal contributions in a base year, 1975-76, are escalated by the rate of growth of GNP. The fourth major federal-provincial shared-cost program, the Canada Assistance Plan, remains on an open-ended, 50:50 cost-sharing basis.

The origin of the EPF arrangements is the federal offer to provinces in the 1960s to "contract out" of certain shared cost programs and receive compensation in the form of a transfer of tax room and cash payments. Only Quebec took advantage of this offer which was subsequently withdrawn. In order to understand why the EPF arrangements evolved as they did, it is necessary to review briefly the shared-cost arrangements which preceded them.

Two facets of the previous shared-cost arrangements are relevant here: the calculation of provincial entitlements and the form of federal contributions.

Although federal payments were based on 50:50 cost-sharing formulae for each of the three "established" programs, the three formulae for calculating provincial entitlements were quite different.

Payments to the provinces under the Hospital Insurance and Diagnostic Services Act, which was passed in 1957, were based on the following formula: a province's entitlement in a given year was equal to 25 per cent of the national average per capita cost of insured services plus 25 per cent of the province's per capita cost of insured services, multiplied by the population of the province in that year. The total federal contribution was equal to about 50 per cent of the cost of insured services in Canada as a whole, but the share of federal support was higher in provinces where the per capita cost was below the national average and lower in the other provinces. This feature of the formula was sometimes referred to as "implicit equalization" and was intended to foster efficiency. Federal contributions to the provinces for hospital care in the base year of the EPF arrangements are set out in Table VI-I.

TABLE VI-1

FEDERAL CONTRIBUTIONS TO HOSPITAL INSURANCE
1975-76

Province	$ Million	$ Per Capita	% Share of Costs
Newfoundland	56.2	102.35	51.6
Prince Edward Island	10.5	89.67	60.3
Nova Scotia	81.8	99.82	54.5
New Brunswick	68.0	102.22	52.8
Quebec	687.5	111.26	47.5
Ontario	879.7	107.65	50.6
Manitoba	110.9	109.41	54.0
Saskatchewan	93.3	102.82	55.4
Alberta	191.0	107.41	49.5
British Columbia	251.3	103.28	52.0
Total	2,430.3	107.28	50.3

Under the federal-provincial agreements pursuant to the Hospital Insurance and Diagnostic Services Act, the provinces were required to make insured services available to all residents of their provinces on "uniform terms and conditions". These insured services included accommodation, meals, necessary nursing services, diagnostic procedures, pharmaceuticals, the use of operating room facilities, radiotherapy and physiotherapy where available, etc. A wide range of out-patient services was also included. Specifically excluded were tuberculosis hospitals, hospitals or institutions for the mentally ill, and institutions providing custodial care, such as nursing homes and homes for the aged.

In the federal Budget of June 23, 1975, notice of the federal intention to terminate the Hospital Insurance agreements at the end of the five-year period required by the Act was given. The purpose of this measure was to facilitate the development of more flexible and less costly arrangements for the funding of hospital care in Canada.

Payments to the provinces under the Medical Care Act, which was passed in 1966, were based on the following formula: a province's entitlement in a given year was equal to 50 per cent of the national average per capita cost of insured services, multiplied by the population of the province in that

year. Hence, although federal contributions to the provinces varied as a share of provincial expenditures, all provinces received what was essentially an equal per capita grant. Federal contributions to the provinces for medical care in the base year of the EFP arrangements are set out in Table VI-2.

TABLE VI-2

FEDERAL CONTRIBUTIONS TO MEDICARE
1975-76

Province	$ Millions	$ Per Capita	% Share of Costs
Newfoundland	20.2	36.79	75.4
Prince Edward Island	4.3	36.72	67.2
Nova Scotia	29.8	36.36	53.4
New Brunswick	24.8	37.28	73.8
Quebec	227.0	36.74	48.4
Ontario	302.0	36.95	49.1
Manitoba	37.9	37.39	59.0
Saskatchewan	34.3	37.80	50.7
Alberta	66.3	37.28	53.2
British Columbia	90.1	37.03	40.8
Total	826.7	36.97	50.0

The per capita amounts in Table VI-2 vary slightly because "total" population was used. On the "net" population basis used for the purpose of administering the program the amounts are equal per capita. "Net" population is equal to "total" population, less inmates of federal penitentiaries and members of the Canadian Forces and the RCMP.

Shareable costs covered all necessary services rendered to insured persons by medical practitioners. The provincial plans were expected to satisfy certain "program criteria" which were contained in the Medical Care Act. They included portability of benefits, comprehensiveness of services, access to those services without excessive user changes, universality of coverage and public administration. The term "national standards" in the health care field usually refers to these "program criteria". (In some contexts, it also refers to the "uniform terms and conditions" under the Hospital Insurance arrangements.)

In the federal budget of June 23, 1975, it was announced that ceilings would be placed on contributions to the provinces for 1976-77 and subsequent years. The purpose of the measure was to cap what would otherwise have remained an open-ended shared-cost program and to encourage more efficient use of medical resources.

The post-secondary education arrangements were implemented in 1967, as part of the fiscal arrangements. Prior to 1967, the federal government made payments to the provinces for technical training and grants to universities through the Association of Universities and Colleges of Canada. Provincial entitlements were calculated on the basis of the following formula: A province's entitlement in a given year was equal to the greater of (a) 50 per cent of the eligible operating expenditures of post-secondary institutions in the province in the year in question or (b) $15 per capita (1967 population) escalated by the rate of growth of eligible operating expenditures of post-secondary institutions in Canada as a whole. Three provinces (Newfoundland, New Brunswick and Prince Edward Island) were paid on the basis of the latter provision. When the arrangements were renewed in 1972 a 15 per cent year-over-year ceiling was placed on the total federal contribution. Federal contributions to the provinces for post-secondary education in the base year of the EPF arrangements are set out in Table VI-3.

TABLE VI-3

FEDERAL CONTRIBUTIONS TO POST-SECONDARY EDUCATION
1975-76

Province	$ Millions	$ Per Capita	% Share of Costs
Newfoundland	27.8	50.63	60.7
Prince Edward Island	6.0	51.24	75.9
Nova Scotia	53.7	65.53	48.8
New Brunswick	34.4	51.71	60.9
Quebec	512.9	83.01	45.5
Ontario	540.1	66.10	49.9
Manitoba	63.8	62.94	48.4
Saskatchewan	52.2	57.53	48.0
Alberta	123.8	69.62	45.6
British Columbia	131.5	54.04	42.6
Total	1,546.2	68.31	47.6

Total federal contributions were below 50 per cent of eligible operating expenditures because of the 15 per cent year-over-year ceiling. In the three provinces paid under the per capita provision, the federal share was above 50 per cent.

The post-secondary education arrangements were originally devised to strengthen the ability of the provinces to meet the then rapidly growing demand for post-secondary education. The provinces were given complete flexibility in structuring their own institutional arrangements and "post-secondary education" was defined as any course of studies requiring junior matriculation or equivalent for admission.

Federal contributions to the provinces took different forms in each of the three "established" programs. The notion of "cash transfers" is self-explanatory but the concept of a "tax transfer" requires a word of explanation. A "tax transfer" in this context is a reduction in federal income taxes accompanied by a corresponding increase in provincial income taxes. One personal income tax point is 1 per cent of basic federal tax and one corporate income tax point is 1 per cent of federal corporate taxable income.

Under the Hospital Insurance program, all provinces, except Quebec, received cash transfers. In Quebec, after the contracting out arrangements were introduced in 1965, there was a special abatement of 16 personal income tax points, with provision for adjustment payments or recoveries as required. This meant that federal taxpayers resident in Quebec reduced their basic federal tax by 16 per cent; the revenue forgone by the federal government as a result of this special abatement was used to offset amounts otherwise payable to the province. The Quebec government then occupied the tax room made available. Quebec's entitlement, i.e., amounts otherwise payable, was calculated in exactly the same way as in the other provinces and so Quebec neither gained nor lost financially as a result of the contracting out arrangements.

Medicare was the simplest of the three "established" programs with cash tranfers being made to all provinces.

Under the Post-Secondary Education arrangements, all provinces received a tax transfer of 4 personal income tax points and one corporate income tax point. These tax points were equalized to the national average under the provisions of the general equalization program. When tax reform was implemented in 1972, the 4 tax points on the personal side were adjusted to 4.357 points to preserve the value of the tax transfer. All provinces received cash adjustment payments equal to the difference between the (equalized) tax transfer and the entitlement in the province as calculated in the manner described above. Although the

relevant legislation provided for cash adjustment payments as necessary, the legislation was silent on the question of recoveries in the event that the value of the tax transfer exceeded the entitlement.

Although the shared-cost arrangements worked well in a number of respects, there were a number of problems with them from the points of view of both the federal government and the provinces. To overcome these mutual problems the federal government and the provinces worked together to develop the EPF arrangements.

The major problems with the shared-cost arrangements from the federal point of view were the following:

(a) The shared-cost arrangements were, in their original form, open-ended with federal expenditure decisions essentially in provincial hands. This meant that the federal government could neither control nor accurately predict costs.

(b) Transfers to the provinces, especially under the post-secondary education program, varied widely in per capita terms and it was thought to be desirable to diminish these discrepancies in the interest of interprovincial equity.

(c) The rigidities of the cost-sharing formulae, especially under the Hospital Insurance program, led to the inefficient allocation of the provinces', and hence, the federal government's resources.

(d) The arrangements were cumbersome to administer because of the process of having the provinces submit claims, subjecting them to audit, negotiating what was or was not eligible for cost-sharing, etc.

Among the problems with the shared-cost arrangements from the provinces' point of view were the following:

(a) The provinces regarded the establishment of the shared-cost arrangements as an unwarranted federal intrusion into areas of provincial jurisdiction, an intrusion which distorted their own spending priorities.

(b) Once the programs were established, the provinces were uncertain about the strength of the federal commitment to them in light of the ceiling on post-secondary education contributions, the notice of termination of the Hospital Insurance agreements and the ceilings on Medicare payments.

(c) The provinces also complained that the lack of flexibility in program design caused them to spend more than they needed to spend to deliver a given level of services.

(d) The provinces objected to the federal auditing of provincial accounts and to the sense that the federal government was looking over their shoulders.

The EPF arrangements were first proposed to the provinces at a First Ministers' Conference on June 14, 1976. The objectives of EPF, as outlined by the Prime Minister at that time, were the following:

(1) "To maintain across Canada the standards of service to the public under these major programs, and to facilitate their improvement;

(2) "to put the programs on a more stable footing so that both levels of government are better able to plan their expenditures;

(3) "to give the provinces flexibility in the use of their own funds which they have been spending in these fields;

(4) "to bring about greater equality among the provinces with regard to the amount of federal funds they receive under the programs;

(5) "to provide for continuing joint policy discussions relating to the health and post-secondary education fields".

Mr. Trudeau went on to identify the principles underlying these objectives as the following:

(1) "The federal government should continue to pay a substantial share of program costs;

(2) "federal payments should be calculated independently of provincial program expenditures;

(3) "there should be greater equality in per capita terms among the provinces with regard to the amount of federal funds they receive under the programs;

(4) "the arrangements for these major programs should be placed on a more permanent footing;

(5) "there should be provision for continuing federal participation with the provinces in the consideration and development of policies of national significance in the fields of health and post-secondary education."

At a subsequent First Ministers' Conference, on December 13, 1976, the then Minister of National Health and Welfare, Mr. Lalonde, stated that, "The introduction of the Hospital Insurance and Medical Care programs into Established Programs Financing would have three very important results:

(1) "First, the movement to block-funding would increase substantially the flexibility available to provinces with regard to program decisions. At the same time, there would be a simplification of administrative procedures;

(2) "second, any savings that can be generated by reducing the services would accrue totally to the provinces and would not be shared by the Federal Government since our contribution under Established Programs would not be directly related to program costs;

(3) "third, all the projections suggest that the Established Programs formula being considered at this time would yield more resources to the provinces than a continuation of current arrangements for the health and post-secondary education programs".

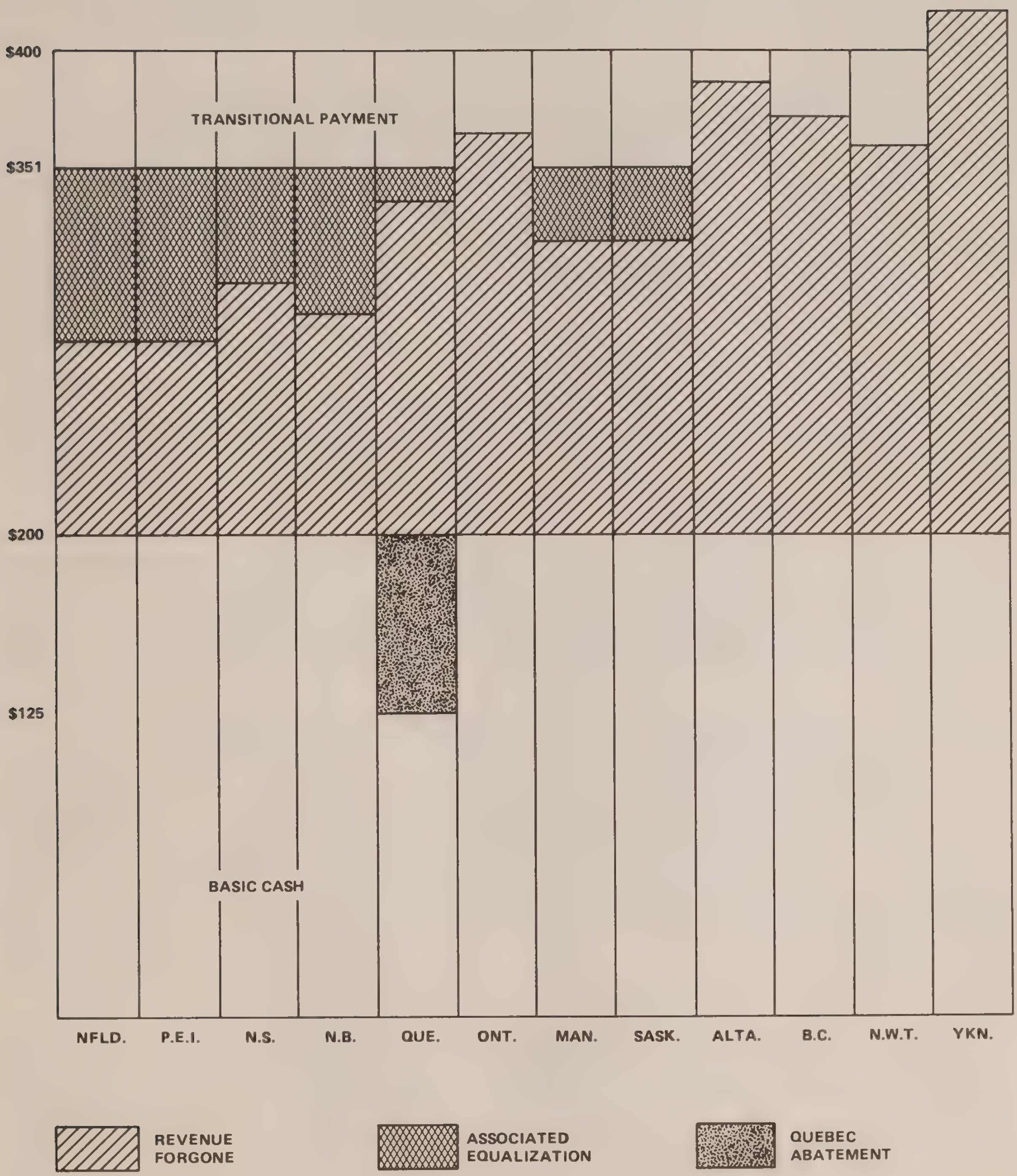
As noted above, the EPF arrangements came into effect on April 1, 1977. Under these arrangements, federal contributions to the provinces for the three "established" programs - Hospital Insurance, Medicare and Post-Secondary Education - are no longer tied to provincial expenditures on the basis of 50:50 cost-sharing formulae. Rather, federal contributions in a base year (1975-76) are escalated by the rate of growth of GNP.

As Chart VI-1 illustrates, the federal contribution under the EPF arrangements is in the form of cash payments and tax transfers. The tax transfer under the EPF arrangements consists of 13.5 personal and one corporate income tax points. These are equalized to the national average under the general equalization formula. The cash payments consist of "basic cash" contributions and "transitional adjustments". The "basic cash" portion is calculated by taking 50 per cent of the federal contributions under the three "established" programs in 1975-76, and escalating them by the rate of growth of GNP. The "basic cash" contributions are intended

CHART VI-1

EPF ENTITLEMENTS PER CAPITA

1980-81



to provide for stable, long-term funding and for continued federal presence. The "transitional adjustments" are equal to the difference, if any, between the value of the tax transfer and the "basic cash" contribution. In other words, the "transitional adjustments" top up the value of the tax transfer to ensure that no province loses as a result of accepting part of the federal contribution in the form of a tax transfer.

Payments to the provinces are made by the program departments. Roughly one-half is allocated to Hospital Insurance, one-sixth to Medicare, and the remaining one-third to Post-Secondary Education.

The above provides an overview of the way the EPF formula works. A more detailed description is provided in the following paragraphs.

The Base Year. Base year contributions under the three "established" programs are displayed in Table VI-4. It should be noted that 1975-76 was selected as an appropriate base year because it was recent enough to be relevant and because the chances for provinces to "load" expenditures into the base year were thought to be minimized because the year had ended before the negotiations began.

TABLE VI-4

BASE YEAR CONTRIBUTIONS TO THE "ESTABLISHED" PROGRAMS 1975-76

Province	$ Millions	$ Per Capita	% Share of Costs
Newfoundland	104.2	189.77	57.4
Prince Edward Island	20.9	178.48	65.9
Nova Scotia	165.3	201.71	52.3
New Brunswick	127.1	191.07	58.1
Quebec	1,427.4	231.01	46.9
Ontario	1,721.8	210.69	50.1
Manitoba	212.6	209.75	53.0
Saskatchewan	179.8	198.15	53.7
Alberta	381.2	214.36	48.7
British Columbia	472.9	194.35	46.7
Total	4,813.2	212.65	49.3

Basic Cash. The so-called "basic cash" contributions to the provinces are calculated using the following formula:

$$\left(\frac{\text{Base Year Contributions Per Capita}}{2} + \$7.63 \right) \text{ X Escalator X Population}$$

As Table VI-4 shows, base year contributions per capita are equal to $212.65. This amount is divided by 2 because half the continuing federal contribution is in the form of cash. To this amount of $106.32 is added $7.63. The latter amount is the cash equivalent of one equalized personal income tax point per capita in 1975-76. This was part of the negotiated settlement. It was intended to provide compensation for termination of the 1972 Revenue Guarantee program and was given to the provinces on the condition that they agreed to integrate the Hospital Insurance program into the EPF arrangements on April 1, 1977. (The provinces had the option of continuing to receive shared cost entitlements for hospital insurance until July 15, 1980 when the Hospital Insurance agreements were due to expire.)

Escalator. The factor used to increase the basic cash per capita from year to year is a three year, compound moving average of nominal GNP per capita.

Population. The population data used for the purpose of the EPF arrangements are those published by Statistics Canada.

Transitional Payments. Transitional payments are equal to the difference, if any, between cash and the tax transfer. They are designed to ensure that no province loses as a result of accepting part of the federal contribution in the form of tax rather than all in cash. In the event that the tax transfer exceeds basic cash in a province, the province keeps the excess. The provinces had requested "equalization to the top". This was not acceptable to the federal government because of the precedent that it could create for the general equalization formula.

The Tax Transfer. As noted above, the tax transfer is equal to 13.5 personal and one corporate income tax points. The corresponding increase in provincial revenues is equalized to the national average under the general equalization formula. Because 4.357 personal and one corporate income tax points had already been transferred to the provinces under the previous Post-Secondary Education arrangements, the federal tax reduction associated with the implementation of the EPF arrangements was the difference between what the provinces had and what they received. This difference is 9.143 personal income tax points. Hence, federal basic tax was reduced by 9.143 per cent on January 1, 1977.

Levelling Adjustments. Because the per capita contributions varied among the provinces in the base year, a mechanism was needed to ensure a smooth transition from the previous, shared-cost arrangements. Provinces above the national average per capita are "levelled down" to the national average by the beginning of the fifth year of the program; those below are "levelled up" by the beginning of the third.

The Tax Transfer Recovery. Because the tax transfer was effected at the beginning of the tax year on January 1, 1977, whereas the EPF arrangements began at the beginning of the fiscal year on April 1, 1977, a portion of the tax transfer in respect of this three month period was recovered from the provinces over the first two years of the program.

The Special Abatement to Quebec. Under the previous shared-cost arrangements for Hospital Insurance, Quebec received a special abatement of 16 personal income tax points. Following the implementation of the EPF arrangements, this special abatement became 8.5 personal income tax points. The value of these 8.5 points is subtracted from the EPF cash transfer and added to the EPF tax transfer in Quebec. Hence the total transfer to Quebec, i.e., cash plus tax transfers, is calculated in precisely the same way as the total transfer in the other provinces; only the form of the transfer differs.

Allocation. As noted above, the cash transfer is allocated among the "established" programs on the basis of the ratios which are obtained in the base year: 50.5 per cent is allocated to Hospital Insurance, 17.4 per cent to Medicare and the remaining 32.1 per cent to Post-Secondary Education. From the point of view of a particular province, these ratios are somewhat arbitrary and, over time, become less closely related to actual provincial spending in the relevant program areas.

Extended Health Care. Prior to the start of the EPF negotiations, the Minister of National Health and Welfare had made a commitment to the provinces to broaden the base of cost-sharing under the health programs in exchange for a commitment from the provinces to set targets for the numbers of acute care beds and medical practitioners. This proposal was designed to increase the flexibility of the provinces in program design and to permit cost saving over time through increased efficiency. Because cost-sharing would come to an end under the EPF arrangements, the base for cost-sharing could no longer be broadened. The federal commitment was therefore met by the introduction of the Extended Health Care program. This program was also designed to cover certain health-related services which were being cost-shared under the Canada Assistance Plan. The Extended Health Care Program is designed to cover the following services: nursing home intermediate care, adult residential care, converted mental hospitals, home care, and ambulatory health care. Payments under this program are equal to $20 per capita in 1977-78, escalated thereafter by the EPF escalator.

The legislative authority for the EPF arrangements is in Part VI of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977. This legislation provides for (a) the calculation of the amounts payable for the four EPF programs and (b) the authority for making payments under the Post-Secondary Education and Extended Health Care programs.

The authority for making payments under the Hospital Insurance and Medicare programs remains in the Hospital Insurance and Diagnostic Services Act and the Medical Care Act respectively. The original "program criteria" remain in force and the Minister of National Health and Welfare has retained authority to withhold payments from a province if the province's health insurance plan does not satisfy the federal conditions. The basic reason for splitting cash payments among the "established" programs is to provide the Minister of National Health and Welfare with an amount which may be withheld from a province.

The legislative authority for the contracting out arrangements with Quebec is in Part VII of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977. The original contracting out legislation, viz.; The Established Programs (Interim Arrangements) Act was repealed when the EPF arrangements were introduced.

The EPF arrangements have no expiry date but the legislation provides that federal government may not modify the arrangements in a way which reduces a province's entitlement without that province's consent prior to March 31, 1982. As of April 1, 1982, however, it is open to the federal government to modify the arrangements in any way short of complete termination. The legislation also provides that complete termination of the arrangements requires prior notice and would take effect on March 31, of the third year after the year in which notice is given. Hence, if notice were given in 1980, for example, it would take effect on March 31, 1983, one year after the end of the current fiscal arrangements period.

In short, the federal government can modify but cannot terminate the arrangements as of April 1, 1982.

Perhaps the major issue which has arisen with respect to the EPF arrangements is whether the additional flexibility the provinces enjoy under the EPF arrangements is compatible with the maintenance of national standards in the health care field. As noted above, the authority for Hospital Insurance and Medicare payments remains in the Hospital Insurance and Diagnostic Services Act and in the Medical Care Act respectively, and the original "program criteria" remain

intact. A central question in this context is whether or not it is possible for the federal government to enforce the national standards and, if so, how. The question of national standards in the area of post-secondary education does not arise in the same form because under the previous shared-cost arrangements for post-secondary education there were no program conditions.

Cash payments to the provinces under the EPF arrangements account for about 9.5 per cent of total federal outlays and it is often felt that the federal government does not receive adequate recognition for its contribution.

ANNEX VII

THE FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS LEGISLATION

Although the financial links between the federal and provincial governments are numerous and varied, the key elements of federal-provincial fiscal relations are embodied in an Act of Parliament entitled *The Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977*; it came into effect on April 1, 1977.

While the major elements of the Act are normally renegotiated every five years, not all parts of the Act expire on March 31, 1982. Indeed, only one major part of the Act expires, i.e., Part I, Fiscal Equalization. The Tax Collection Agreements and the Established Program Financing arrangements, under Parts III and VI of the Act respectively, do not expire. Nevertheless, the convention of re-examining the Act and introducing a new Act every five years is well established.

The Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977 has 10 parts.

Part I empowers the Minister of Finance to make fiscal equalization payments to provincial governments. This is a large and significant program which is intended to mitigate the fiscal aspects of regional economic disparities through unconditional transfers to the governments of the disadvantaged provinces.

Part II empowers the Minister of Finance to make fiscal stabilization payments to provinces. This section would only come into play if a serious regional or national recession were encountered. It has never been necessary to make payments under this provision. This provision has been of obvious value to provinces when they borrow in foreign capital markets.

Part III enables the Minister of Finance to enter into income tax collection agreements with provincial governments. The income tax collection agreements are clearly a very important feature of the fiscal arrangements.

Part IV enables the Minister of Finance to make revenue guarantee payments to provinces. The current revenue guarantee provision involves the personal income tax and is designed to ensure that provincial revenues do not decline in the event of a change by the federal government in federal basic tax at a time when the provinces who have entered into tax collection agreements in respect of the personal income tax are unable to make a compensating change. ("Federal basic tax" is the base to which provincial personal income tax rates apply in agreeing provinces.)

Part V enables the Minister of Finance to make payments to provinces to share a portion of the federal tax on the payout of 1971 undistributed corporate income on hand. This provision relates to the 1972 tax reform. The relevant provision of the federal Income Tax Act was repealed effective December 31, 1978, and payments under this part will soon be completed.

Part VI describes the computation of payments under the Established Programs Financing arrangements. These arrangements provide for a method of determining the federal contributions for Hospital Insurance, Medicare and Post-Secondary Education which differs from the method under the previous shared-cost arrangements. Payments under EPF are no longer related to program expenditures by provinces, but rather are based on contributions in a base year, 1975-76, escalated by the growth of the economy.

Part VII provides for a continuation of the contracting out arrangements with Quebec.

Part VIII enables the Minister of Finance to enter into reciprocal taxation agreements with provinces whereby provinces pay the federal manufacturers sales tax and the federal government makes payments in respect of provincial sales taxes and motor vehicle licence fees as if it were taxable. These agreements with the six easternmost provinces are working well and new agreements for the period April 1, 1981, to March 31, 1987, have just been signed.

Part IX provides the Minister with the power to make regulations pursuant to the Act. Part X provides for necessary consequential amendments to relevant legislation. Parts IX and X are both housekeeping parts of the Act.

Payments under the Act, except for the tax collection and EPF payments, are considered in the Fiscal Transfers Envelope under the envelope expenditure management system.

Established Programs Financing payments, while computed in accordance with provisions of the fiscal arrangements legislation, remain the responsibility of the Minister of Health and Welfare and the Secretary of State.

The authority and conditions for the Hospital Inusrance and Medicare cash payments are still found in the Hospital Insurance and Diagnostic Services Act and in the Medicare Act. As a result, EPF cash payments are included in the Social Development Envelope.

Tax collection payments are provincial own-source revenues collected on their behalf by the federal government.

The fiscal arrangements have normally been renegotiated by the Minister of Finance since he has over-all responsibility for the relevant legislation. Other ministers have been involved as necessary. The Minister of Finance and his provincial counterparts meet at conferences of finance ministers and provincial treasurers. These conferences are supported by the Federal-Provincial Continuing Committee on Fiscal and Economic Matters - the continuing committee of deputy ministers; the deputy ministers in turn are supported by a number of permanent and ad hoc subcommittees.